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Supreme Court, U.S.
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No.

**IN THE**

**SUPREME COURT OF THE UNITED STATES**

October Term, 1996

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T. BRUCE VEST AND E.P. VEST,

Petitioners,

vs.

COMMISSIONER OF THE INTERNAL REVENUE DEPARTMENT,

Respondent.

---

Petition for a Writ of Certiorari to the United States Court of Appeal for the Seventh Circuit

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# PETITION FOR A WRIT OF CERTIORARI

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September 20, 1996

140 pp

## QUESTIONS PRESENTED FOR REVIEW

(1) Did the Seventh Circuit's opinion conflict with Supreme Court precedent and other Circuits when it held that the due process clause does not guarantee to a taxpayer a right to confront the witnesses and evidence against him in a tax proceeding for underpayment of tax and fraud?

(2) Did the Seventh Circuit unconstitutionally construe Federal Rule of Evidence 804(b)(5) (the "catch-all exception to the Hearsay Rule) when it sanctioned the introduction of an affidavit taken by an IRS Agent when the declarant had a motive to falsify and was unavailable for cross-examination, in a proceeding to assess a 50% tax penalty for fraud?

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## PARTIES TO PROCEEDINGS

The parties to the proceedings were the taxpayers, Dr. T. Bruce Vest and his wife, E.P. Vest. The Vests are the Petitioners herein.

The Respondent is the Commissioner of the Internal Revenue Service.

No._____

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**PETITION FOR A WRIT OF CERTIORARI**

---

Petitioners, Dr. T. Bruce Vest and his wife, E.P. Vest, respectfully Petition for a Writ of Certiorari to review the Judgment and Order of the United States Court of Appeals for the Seventh Circuit entered on June 24, 1996.

## OPINION BELOW

The June 24, 1996 Order, Judgment and Opinion of the Seventh Circuit Court of Appeals is an unpublished order not to be cited per Circuit Rule. The Opinion of the Seventh Circuit is reprinted in the Appendix beginning at page A66.

The Seventh Circuit Opinion is from an order of the United States Tax Court entered on May 27, 1993 and cited as Tax Court Memorandum 1993-243, Docket Number 19071-87. (A1-A65) The Tax Court Memorandum Opinion is set out in full in the Appendix.

## JURISDICTION

The United States Supreme Court has jurisdiction to review the Seventh Circuit Court Judgment pursuant to 28 USC Sec. 1254(1). The Seventh Circuit Court had jurisdiction to review the Tax Court findings pursuant to 26 USC Sec. 7482, 28 USC Sec. 41 and 28 USC Sec. 1291. The Tax Court had jurisdiction to hear the original case pursuant to 26 USC Sec. 7442 (1986).

## STATUTORY PROVISIONS INVOLVED

Petitioner raises his due process argument under the United States Constitution.

The Fifth Amendment to the Constitution states, in pertinent part:

> "No person...shall be ...deprived of life, liberty, or property, without due process of law...".

The Sixth Amendment to the United States Constitution also guarantees the right to confront the witnesses against a defendant.

Federal Rule of Evidence 804, concerning the admissibility of certain hearsay statements, is also implicated in this Petition.

The Fifth and Sixth Amendments to the Constitution and Federal Rule of Evidence 804(b)(5) are set out in full in the Appendix. (A77-79)

## STATEMENT OF THE CASE

Petitioners', Dr. Vest and Mrs. Vest, were subject to an Internal Revenue Service audit for the tax years 1981 through 1984. The Internal Revenue Service assessed tax deficiencies and penalties for fraud in a sum in excess of $300,000. (A67) The Tax Court found Dr. Vest guilty of intentional fraud. The Vests appealed this Tax Court ruling to the Seventh Circuit Court of Appeals. The Seventh Circuit Court of Appeals upheld the tax deficiencies and finding of fraud. It is from this

ruling that the Vests' Appeal for this Court to grant a Petition for Writ of Certiorari.

Dr. Vest is a doctor who specializes in radiology. In 1981, while he was the head of the Radiology Department for Wood River Township Hospital, he proposed that the hospital invest in a CAT scanner. Due to financial considerations, the hospital did not want to purchase the scanner. In 1983 Vest proposed to purchase the scanner and lease it to Wood River Township Hospital. (A67) Vest then purchased the scanner and leased it to the hospital. The hospital paid Vest monthly. The scanner was upgraded by Vest after the initial agreement and an additional sum of money was paid monthly for the upgrade.

During the Internal Revenue Service audit, Dr. Vest produced an "Operating Agreement" which, by its terms, made the length of the lease two years. Subsequently, a "Contract for Lease" was located at the Wood River Township Hospital covering the same subject matter. The "Contract for Lease" was for a term of seven years. (A70)

Under IRS regulations in effect at the time of these transactions, an agreement such as the one under consideration here would qualify for an investment tax credit if its term was two years. However, if the term

was for seven years, the investment tax credit would not apply. (A70) Losing the investment tax credit meant that Dr. Vest had understated his income. Substantial penalties and interest flowed from that event. The IRS also sought penalties for fraud which required the Government to prove specific intent to evade paying a tax.

During the Tax Court trial, Dr. Vest testified that the "Contract for Lease" was merely an initial introductory proposal (A108) and that the "Operating Agreement" governed the transaction. In fact, the "Contract for Lease" called for payments of $18,635 per month whereas the payments made to Dr. Vest were in the amount of $20,605. (The IRS contended at the trial that the additional $1,970 was for the upgrade of the equipment.) Dr. Vest contended at the hearing that the "Operating Agreement" clearly set out the monthly payments to be $20,300 per month and that the payments made by the hospital were pursuant to the "Operating Agreement" and not the "Contract for Lease". The date of the "Operating Agreement" is December 22,1983, soon after the installation of the upgraded scanner.

Wood River Hospital regulations required that the Board of Directors approve any contract whose value was in excess of $5,000. (A96) Although Eugene Cowsert, the CEO of Wood River

Hospital, testified that the Hospital Board of Directors approved the "Contract for Lease" and upgrade, he could locate no Board minutes where permission for either action was approved. (A102-104). The "Contract for Lease" was undated (A97) and contained language stating that Dr. Vest "proposes to lease" the scanner to the hospital.

George Myers was Chairman of the Board of Wood River Hospital until May of 1983. Dr. Vest provided Mr. Myers with the Operating Agreement but did not see him sign this agreement. (A91-92) Dr. Vest testified he believed the Operating Agreement provided to the IRS was a valid contract and a genuine copy of the original. (A89-90) However, testimony at the hearing from a handwriting expert indicated that Mr. Myers had not signed the Operating Agreement. But no testimony could show who signed the agreement, although Dr. Vest's handwriting was compared to the signature on the "Operating Agreement". (A105, A106-107). The tax liability depended upon which of the two agreements was valid.

The IRS procured an affidavit from George Myers on June 19, 1986. The IRS agent and his group manager met with Cowsert and Myers in their offices. One IRS agent administered an oath to Myers, who then executed an affidavit. (A93-95) The affidavit

stated that the signature on the "Operating Agreement" was not that of Myers and "I do not recall seeing this prior to today." (A18) The Tax Court predicated its finding of fraud and the 50% assessments on the affidavit of Myers.

According to Mr. Cowsert, fierce competition existed between the hospitals in the Alton area for patients, skilled physicians, and diagnostic equipment. (A101) Dr. Vest and the hospital had unsuccessful negotiations about pursuing a joint venture to open a diagnostic clinic and Dr. Vest thereafter decided to open a clinic on his own. (A109) After announcing his plan to create Doctors Clinic, Mr. Cowsert became very angry with Dr. Vest and both Mr. Cowsert and Myers voted to terminate Dr. Vest's 15 year contract with Wood River Township Hospital. (A86)

A tax proceeding was initiated by the IRS and in June of 1988 Dr. Vest filed his initial request for discovery. Approximately one month later in July of 1988 the IRS refused to send the Myers affidavit to Dr. Vest. In fact, on August 19, 1988 the IRS informed Dr. Vest of the contents of the affidavit but "for strategic reasons" would not send Dr. Vest a copy of the affidavit. (A81) Without the actual affidavit, much less a copy, Dr. Vest could not have the handwriting analyzed.

Throughout the month of August, September, and October, the IRS refused to comply with the discovery demands of Dr. Vest, including a demand that the affidavit be produced. Motions to compel production of this affidavit and other information were filed during these months, with the IRS tentatively agreeing to answer the discovery request and then, for various reasons, including "car trouble" delayed and did not send the discovery to the Petitioner. (A83-85)

Myers died on October 20, 1988, prior to the trial of this case. At the trial, the affidavit of Myers was presented as substantive truth of the facts asserted therein, under Federal Rule of Evidence 804(b)(5), the "catch-all" exception to the hearsay rule. (A71) Dr. Vest's attorneys strenuously objected to the admissibility of the Myers affidavit. (A87-88, A98-100)) These objections went to the trustworthiness of the affidavit, including whether Myers had a motive to lie (he had serious business disputes with Dr. Vest and had voted to terminate him once Dr. Vest opened his own clinic); whether Myers had a motive to lie about the "Operating Agreement" (hospital regulations required contracts such as this to be approved by the Board, but it was not approved and Myers would have a motive to deny that he signed under those circumstances); that Myers was an older person, who

was experiencing heart trouble and on occasion was forgetful. Furthermore, Petitioners argued that since they did not have an opportunity to cross-examine Myers, the Tax Court did not have an opportunity to observe his demeanor. Counsel for Dr. Vest also asserted that no foundation was laid as to the circumstances surrounding Myers' questioning or as to interrogation methods used on Myers by the IRS agents when the affidavit was taken, or as to Myers' mental capacity, and whether or not Myers understood the terms of the affidavit.

Petitioners had no opportunity to develop any traditional biases or motives Myers may have had in executing a false affidavit. There was absolutely no opportunity for Petitioners to delve into Myers' mental capacity or his ability to remember. Because the Board never formally approved the "Contract for Lease", inquiry could also have been made as to whether Myers or other members of the hospital administration were attempting to conceal their failure to comply with hospital regulations regarding approval of leases. This failure could warrant criminal charges under Ill. Rev. Stats. Ch. 17 Sec. 1558-1 (A80).

The Tax Court accepted the Myers affidavit as substantive evidence and relied heavily on that affidavit, not

only in finding that the investment tax credit did not apply, but also in making a finding of fraud against Dr. Vest. (A52) The Tax Court and the Seventh Circuit Court of Appeals relied heavily, if not exclusively, on the affidavit of Myers in determining that Dr. Vest had the specific intent to evade tax, and found him guilty of having committed fraud. The Tax Court imposed the harsh 50% penalty sanction upon him for that fraud.

Petitioners also deducted from their taxes the cost of a temporary building used to temporarily house the CAT scanning equipment at Doctors Clinic before the completion of the clinic building. Dr. Vest contended that he should be allowed to deduct the expenses of a temporary structure which had a useful life of less than one year. He also contended that he should have been allowed to deduct a $10,000 preliminary design fee. The temporary structure was in fact demolished in 1986. Although Dr. Vest paid $52,000 for this temporary structure in 1984, the Tax Court disallowed this deduction as a Schedule C deduction holding that the temporary structure in fact was a permanent building and should have been depreciated rather than written off. The Tax Court's finding on this issue was clearly erroneous, and jaded by the improper introduction of the Myers affidavit.

The Seventh Circuit Court of Appeals upheld the lengthy (65 page) Tax Court opinion, also relying heavily on the Myers affidavit for proof of intentional fraud. This Petition for Writ of Certiorari followed the decision of the Seventh Circuit Court of Appeals.

## REASONS FOR GRANTING THIS PETITION

### I. THE PETITIONER'S DUE PROCESS RIGHT TO CONFRONT THE WITNESSES AGAINST HIM WAS DENIED WHEN THE MYERS' AFFIDAVIT WAS ADMITTED OVER THE OBJECTION OF THE DEFENSE. THE SEVENTH CIRCUIT'S OPINION CONFLICTS WITH ESTABLISHED SUPREME COURT PRECEDENT AND WITH OTHER CIRCUITS.

The decision of the Seventh Circuit Court of Appeals in this case conflicts with established Supreme Court precedent reaching as far back as 1913. The use of a purely hearsay affidavit in a tax proceeding for fraud violates the Due Process Clause of the Constitution, and past Supreme Court precedent, and is in conflict with other Circuits.

In almost every setting where important decisions turn on questions of fact, due process requires an opportunity to confront and cross-examine adverse witnesses. ICC v. Louisville, 227 U.S. 88, 93-94 (1913). "Where Governmental action seriously injures an individual, and the reasonableness of the action

depends on fact findings, the evidence used to prove the Government's case must be disclosed to the individual so that he has an opportunity to show that it is untrue. While this is important in the case of documentary evidence, it is even more important where the evidence consists of the testimony of individuals whose memory might be faulty or who, in fact, might be perjurers or persons motivated by malice, vindictiveness, intolerance, prejudice, or jealousy. We have formalized these protections in the requirements of confrontation and cross-examination. They have ancient roots. They find expressions in the Sixth Amendment..." Green v. McElroy, 360 U.S. 474, 496-497 (1959). (Emphasis added.)

While the Sixth Amendment Confrontation Right is ingrained in the Constitution in criminal proceedings, the right of cross-examination and confrontation is also inherent in the Due Process Clause where governmental action is involved. The Right of Confrontation has consistently been upheld when the Government attempts to deprive a citizen of life, freedom, or property. In this case, the IRS is attempting to deprive Dr. Vest of substantial properties (over $300,000) due to a charge of fraud. Although this is not a criminal case per se, this fraud charge is, at least, quasi-criminal. The penalties

imposed on Dr. Vest have all the indicia of punitive rather than regulatory sanctions and the proof of fraudulent intent by clear and convincing evidence both point to the criminal nature of this IRS proceeding. Of the factors noted by this Court in regard to whether or not a sanction is civil or criminal in nature, the necessity of a finding of scienter, and the excessiveness of the fine (50% plus interest) are elements showing that this proceeding was criminal rather than civil (Kennedy v. Martinez, 372 U.S. 144, 168 (1963).

The Confrontation Right is so basic to a fair trial or hearing, that Courts have consistently acknowledged that the basic right of confrontation has application broader than criminal trials alone. For example, this Court has held that a welfare recipient has a right to confront adverse witnesses prior to his welfare benefits being withdrawn. Goldberg v. Kelly, 397 U.S. 254 (1969). In Goldberg, the Court noted that "Relevant constitutional restraints apply as much to the withdrawal of public assistance benefits as to disqualification for unemployment compensation, Shearbert v. Verner, 374 U.S. 398 (1963); or to denial of a tax exemption, Speicer v. Randall, 357 U.S. 513 (1958); or to discharge from public employment, Slochower v. Board of Higher Education, 350 U.S. 551 (1956)."

Goldberg, Supra, at page 397.

Similarly, the Tenth Circuit Court of Appeals has held that the right to a pilot's license cannot be withdrawn by a Government agency until the pilot under question was provided with an opportunity for rebuttal, which includes a right of cross-examination:

> "Certain principles have remained relatively immutable in our jurisprudence. One of these is that where Governmental action seriously injures an individual, and the reasonableness of the action depends on fact findings, the evidence used to prove the Government's case must be disclosed to the individual so that he has an opportunity to show that it is untrue."

Bennett v. National Transportation Safety Board, 55 F.3rd 495, 501 (10th Cir., 1995).

This Court held in Green v. McElroy, Supra, that the Government may not withdraw a security clearance from an individual until he has had the opportunity to confront or cross-examine the witnesses against him.

These cases and others assert the fundamental principal that the right of confrontation is a constitutional right to be enjoyed

not only by criminals, but also in most cases where administrative and regulatory actions are under scrutiny.

Indeed, the Seventh Circuit Court of Appeals itself has held that due process requires notice of the charges and an opportunity for hearing appropriate to the nature and gravity of those charges. Buttitta v. Chicago, 9 F.3d 1198 (7th Cir., 1993).

Although in recent years the Supreme Court has somewhat curtailed a literal application of the "Right to Confront", it has always held that the right to confront the witnesses is one of the most fundamental and important rights in the Bill of Rights. While the Courts have held that the Confrontation and Due Process clauses do not necessarily require that cross-examination of adverse witnesses take place at the hearing or trial, some kind of effective cross-examination is required in order to satisfy the Constitution. For example, while a Preliminary Hearing confrontation right may satisfy the Sixth Amendment for purposes of a criminal trial (Ohio v. Roberts, 448 US 56(1980)), the cross-examination necessary to comport with due process requires some sort of meaningful confrontation and cross examination at some point.

Since the Seventh Circuit has

now held that the fundamental right to confront witnesses is not applicable to Tax Court proceedings (in this case), it appears to be in direct conflict with the United States Supreme Court rulings in Goldberg, Shearbert, Speicer, Slowchower, and Greene, Supra. The Seventh Circuit opinion in the instant case also conflicts with the Tenth Circuit in Bennett.

For the foregoing reasons, this Court should grant the instant Petition in order to bring the Seventh Circuit in conformity with the Supreme Court opinions and precedent.

## II. THE RULING BELOW CONSTRUES FEDERAL RULE 804(b)(5) IN AN UNCONSTITUTIONAL MANNER.

The ruling below construed Federal Rule of Evidence 804 in an unconstitutional manner. The truthfulness and believability of the Myers affidavit was highly questionable. Myers' testimony should have been subject to pointed cross-examination and his believability was highly vulnerable. Denying the taxpayer his right of cross-examination in this case is a denial of due process.

If this Seventh Circuit ruling is allowed to stand, Federal Rule of Evidence 804 is unconstitutional as applied. The ruling abolishes a

fundamental constitutional right and allows a vice that the Hearsay Rule and Confrontation Right guarded against:

"...the particular vice that gave impetus to the confrontation claim [the Hearsay Objection and the Confrontation Clause] was the practice of trying defendants on evidence which consisted solely of ex parte affidavits or depositions secured by the examining magistrates, thus denying the defendant the opportunity to challenge his accuser in a face to face encounter in front of the Trier of Fact." California v. Green, 399 US 149, 156 (1969).

Although the taxpayer was prepared to question Myers' motive for testifying, his interest in the outcome of the litigation, his competency to remember, and the circumstances surrounding taking the affidavit, all of this probative cross-examination was denied the taxpayer when Myers died and the Court admitted and heavily relied upon his affidavit. There was ample evidence supporting the contention that the "Operating Agreement" was the controlling one. There also existed ample evidence that the Myers' affidavit was not to be taken at face value.

The Confrontation Clause bars the admission of some hearsay evidence that would otherwise be

admissible under an exception to the hearsay rule. California v. Green, 333 US 149, 155 (1970). And while firmly rooted exceptions to the hearsay rule carry with them an "indicia of reliability" (see, for example Bourjaily v. US, 483 US 171 (1987), the residual hearsay exception set out in Subp. (5) of Rule 804 falls into a different category. Such "residual exceptions" are "presumptively unreliable and inadmissible for Confrontation Clause purposes". Lee v. Illinois, 476 US 530, 544 (1986) and Idaho v. Wright, 497 US 805, 818 (1990).

Rulings from this Court have indicated that, to be admissible under the "catch-all exception", the hearsay evidence must be "so clear from the surrounding circumstances that the test of cross-examination would be of marginal utility." Idaho v. Wright, 497 U.S. 805, 820 (1990), and that the statement under scrutiny be free from "the risk of inaccuracy and untrustworthiness, so that the test of cross-examination would be a work of supererogation". Idaho v. Wright, Supra, at page 819.

The residual hearsay exception found in Rule 804(b)(5) should be used very rarely, and only in exceptional circumstances. The residual exceptions are not meant to authorize major judicial revisions of the hearsay rule. U.S. v. Flaq 919 F.2d 497, 499 (8th Cir., 1990).

In order to be admissible under the catch-all exception, the statement must have sufficient circumstantial guarantees of trustworthiness. This is so because a person is more apt to tell the truth if required to point the finger of accusation directly at the accused; and the truth is more likely to emerge if that accusation can be tested through the rigors of cross-examination.

"The means of testing the accuracy of a witness is so important that the absence of proper confrontation at trial 'calls into question the ultimate integrity of the fact-finding process. Chambers v. Mississippi, 410 US 284, 295, (1973), quoting Berger v. California, 393 US 314, 315 (1969)", Ohio v. Roberts, 448 US 56, 64 (1980.)

"A personal examination and cross-examination of the witness, in which the accused has an opportunity, not only of testing the recollection and sifting the conscious of the witness, but of compelling him to stand face-to-face with the Jury in order that they may look at him, and judge by his demeanor upon the stand and the manner in which he gives his testimony whether he is worthy of believe" is essential to a fair trial. Mattox v. United States, 156 US, 237 at 242-243 (1895).

The opportunity to confront

witnesses promotes the perception of fairness engendered by having the accused and accuser in an open and even contest in a public trial.

As far back as 1935 this Court held in California v. Green, 399 U.S. 149, 158 that the Confrontation Right "forces the witness to submit to cross-examination, the 'greatest legal engine ever invented for discovery of truth'"; and "permits the Jury that is to decide the Defendant's fate to observe the demeanor of the witness...".

In the instant matter, not only was the Court deprived of the ability to judge the demeanor of witness Myers whatsoever, it was almost completely in the dark as to the circumstances surrounding the taking of Myers' affidavit.

Myers' affidavit was taken after a confrontation at IRS offices with two IRS agents, one being the questioner and the other administering an oath to Myers. What questions led to Myers' statements? How long had Myers been questioned, and what was the tone of the questioning? Were the IRS agents threatening Myers with action if he did not support their theory of the case? Was Myers concerned that violating Wood River Township Hospital rules regarding entering into contracts in excess of $5,000 could subject him to civil and

possibly criminal liability? (See A299, Illinois Revised Statutes Ch. 17 Sec. 1558 making it a Class 3 Felony for Myers to have acknowledged that the "Operating Agreement" was valid without Board Consent.) What mental condition was Myers in at the time he signed the affidavit? Was he good at remembering or were the facts in the affidavit supplied by the IRS agents?

None of the above questions could be addressed at the trial since Myers was dead and his affidavit was entered into evidence without the opportunity to question him. In addition, all of the traditional factors involved in questioning a witness, including his bias, his opportunity to observe, his current motivations, his mental state, and even his demeanor were elements of reliability that were bypassed using the "catch-all" exception to the hearsay rule.

Many Federal Courts and at least two other Circuits have refused to broadly construe the "catch-all" exception to the hearsay rule. The Ninth Circuit, construing Rule 804(b)(5), prohibited a detective's hearsay testimony since it lacked guarantees of trustworthiness in Guam v. Ibanez, 880 F.2nd 108 (1989). Testimony of hospital personnel was held inadmissible under Rule 804(b)(5) in Dogan V. Hardy, 587 F.2d 967 (1984). Even tape recorded

testimony of a witness was inadmissible under Rule 804(b)(5) in Nickleson V. Rushen, 767 F.2d 1426 (9th Cir., 1985) because it did not demonstrate circumstantial guarantees of trustworthiness.

The Sixth Circuit, in reversing the conviction of the defendant in United States v. Gomez-Lemos, 939 F.2d 326, held that the proffered evidence was inadmissible under the residual exception to the Hearsay Rule 804(b)(5). All of these cases properly and constitutionally construed Rule 804.

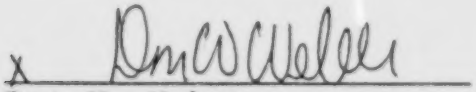
In this case, substantial fraud penalties were levied against the taxpayer based almost entirely on the uncross-examinable affidavit of a deceased witness. This witness had ample motive to fabricate, his testimony was inconsistent with other testimony in the case, and the circumstances under which the statement was given were obscured, at best. Under these circumstances, the broad application of Federal Rule of Evidence 804(b)(5) rendered by the Seventh Circuit was unconstitutional, since it substantially deprived the taxpayer of his right to confront the witnesses against him, in absence of the important and elevated indicia of reliability necessary to admit such evidence.

FRE 804(b)(5) is unconstitutional as broadly applied

in this case and the Supreme Court should grant this Petition in order to set out the correct parameters for admitting hearsay evidence under the catch-all exception to the Hearsay Rule found in Subparagraph (5).

Allowing the ruling below to stand would open the flood-gates for otherwise inadmissible and substantially doubtful hearsay evidence. To allow IRS agents to submit purely hearsay evidence, taken under circumstances known only to the IRS itself, is unconscionable and unconstitutional. This Court must clearly set out the parameters for the admissibility of purely hearsay statements under the "catch-all" hearsay exception.

Respectfully submitted,



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September 20, 1996

# APPENDIX

T.C. MEMO. 1993-243

UNITED STATES TAX COURT

T. BRUCE VEST AND E. P. VEST,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 19071-87

Filed May 27, 1993.

Steven H. Akre, for petitioners.

David R. Reid, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHALEN, Judge: Respondent determined the following deficiencies in and additions to the Federal income taxes of T. Bruce and E. P. Vest:

Additions to Tax

| Yr | Defi-ciency | Sec.66 53(a), (a)(1) | Sec.66 53(a) (2) | Sec.66 53(b), (b)(1) | Sec.66 53(b) (2) | Sec. 6661 |
|---|---|---|---|---|---|---|
| 81 | $17,720 | $886 | -- | -- | -- | -- |
| 82 | 65,800 | -- | -- | $32,900 | --$16,450 | |
| 83 | 186,906 | -- | -- | 93,453 | (1) 46,727 | |
| 84 | 50,541 | 2,527 | (1) | -- | -- | 7,853 |

(1) Fifty percent of interest on underpayment.

All section references are to the Internal Revenue Code as amended and in effect for the years in issue.

After concessions, the following issues are presented for decision: (1) Whether the affidavit of a deceased individual is admissible into evidence pursuant to rule 804(b)(5) of the Federal Rules of Evidence; (2) whether petitioners are entitled to investment credit based upon their investment in a Model 9800 Scanner System; (3) whether petitioners are entitled to deduct a warranty expense related to the Model 9800 Scanner System; (4) whether the gain realized from petitioners' sale of a Model 7800 Scanner System to St. Joseph's Hospital is a capital gain because the sale constituted an "involuntary conversion"; (5) whether petitioners are entitled to deduct the construction costs and retainer fee paid in connection with the construction of two buildings; (6) whether the underpayments of tax for 1982 and 1983 are due to fraud

on the part of petitioner T. Bruce Vest; (7) whether the underpayments of tax for 1981 and 1984 are due to negligence; (8) whether assessment of any tax deficiency or additions to tax for 1982 is barred by the period of limitations on assessment set forth in section 6501(a); and (9) whether petitioners are liable for the addition to tax under section 6661 for substantial understatement of income tax.

## FINDINGS OF FACT

Some of the facts have been stipulated by the parties. The Stipulation of Facts and First Supplemental Stipulation of Facts filed by the parties are hereby incorporated in this opinion. Petitioners are husband and wife. They resided in Godfrey, Illinois, at the time they filed the petition which is the subject of this case. In this opinion, references to petitioner are to T. Bruce Vest.

Petitioner is a medical doctor who specializes in radiology. During 1981, he was the head of the radiology department at Wood River Township Hospital (Wood River Hospital), a political subdivision community hospital, organized under the laws of the State of Illinois. During 1981 through 1984, petitioner was employed by and provided x-ray services through Vest Medical Consultants, Ltd. (Vest Medical). Petitioner held an ownership interest in Vest Medical, but the record does not reveal how much he owned or when he owned it.. Petitioner owned various x-ray equipment through a sole

proprietorship, Computerized X-Ray Services (Computerized X-Ray).

Transaction With Wood River Hospital

In 1981, petitioner recommended that Wood River Hospital purchase a General Electric Model 8800 Scanner System (Model 8800 Scanner) for use in its radiology department. At that time, the Model 8800 Scanner was the state-of-the-art technology in the field of "CAT scanning". In August 1982, Wood River Hospital applied to the Illinois Health Facilities Planning Board for a Certificate of Need, as required for an Illinois hospital to operate a CAT scanner. The application was granted. At a meeting on October 27, 1982, the board of directors of Wood River Hospital (the board) approved the purchase and installation of a Model 8800 Scanner.

In April of 1983, before Wood River Hospital had purchased the Model 8800 Scanner, General Electric (GE) began to market the model 9800 Scanner System (Model 9800 Scanner), a technological advance from the model 8800 Scanner. Petitioner recommended that Wood River Hospital purchase the Model 9800 Scanner in lieu of the Model 8800 Scanner. Members of the board expressed financial concerns about purchasing a more expensive piece of equipment. To circumvent those concerns, petitioner wrote a letter dated May 6, 1983, to the president of Wood River Hospital, Mr. W. Eugene Cowsert, in which petitioner proposed to purchase a Model 9800 Scanner and lease it to Wood River Hospital. He proposed a monthly lease payment of $18,650 consisting of

$13,650, the monthly amount that Wood River Hospital would have paid to purchase a Model 8800 Scanner, plus an additional amount of up to $5,000 to be paid each month only if the revenues produced by the system exceeded $20,000 per month (50 CAT scans).

Subsequently, in an undated installment contract with GE, petitioner, acting on behalf of Computerized X-Ray, agreed to purchase a Model 9800 Scanner for $1,060,200 plus $42,408 sales tax, for a total of $1,102,608. Petitioner agreed to pay that amount, less a down payment of $111,983.62, plus a finance charge of $506,209.06, for a total of $1,496,833.44 in 83 monthly installments of $17,819.44 and one installment of $17,819.92.

During 1983, it was the responsibility of the president of Wood River Hospital, Mr. Cowsert, to review all contracts on behalf of the hospital. He would ask the hospital's board of directors for its approval of any contract under which the hospital would be required to make payments in excess of $5,000. The chairman of the board would sign any such contract on behalf of the hospital.

On April 28, 1983, Mr. George Myers, acting in his capacity as chairman of the board, and petitioner, acting on behalf of Vest Medical, entered into a Radiology Agreement, under which petitioner agreed to provide certain radiology services to the hospital. The term of the Radiology Agreement was 3 years, beginning May 1, 1983, but it was terminable by either

party on 90 days' notice. The board approved the Radiolology Agreement at a meeting on April 28, 1983.

On May 25, 1983, the board elected Mr. Dale Dickerson to replace Mr. Myers as chairman. At a meeting of the board on June 22, 1983, it agreed "to upgrade the 8800 CAT Scan to the 9800 CAT Scan as approved by the Illinois Health Facilities Planning Board". Thereafter, Mr. Dickerson, acting as chairman of the board, executed an undated document entitled Contract for Lease of 9800 GE CAT Scanner (hereinafter referred to as Contract for Lease). That document states as follows:

CONTRACT FOR LEASE OF 9800 GE CAT SCANNER

Computerized X-Ray Services proposes to lease to Wood River Township Hospital a GE 9800 CAT Scanner, specifications which are detailed in the accompanying contract, for a monthly installment of $18,635.00 for a total of eighty-four (84) months.

A monthly payment of $13,635.00 is to be made each month and an additional amount up to $5,000.00 is to be made subject to monthly billing in excess of $20,000.00. Amounts less than the $5,000.00 per month may be carried at 9.5% interest rate until such time that the additional amounts are paid.

The monthly rate after the eighty-fourth payment will be $13,635.00 until such amount of deferred payment is completed.

The GE 9800 Scanner would have a company warranty for twelve (12) months as per standard contract. Wood River Township Hospital would receive title to the Scanner after the payment of the equivalent of eighty-four monthly installments of $13,635.00 has been completed.

Wood River Township Hospital would be responsible for the maintenance of the equipment and for insurance to cover the cost and protection of the equipment until such time they receive title to the equipment.

Additional terms and conditions are detailed in the accompanying equipment description and installment purchase contract.

Equipment is to be installed beginning the latter part of June, 1983, subject to adequate site preparation.

Wood River Township Hospital agrees to provide office space for Administrative and Clerical work necessary to implement the professional management by Vest Medical Consultants, Ltd. as per prior contract with this corporation.

| | |
|---|---|
| /s/ Bruce Vest MD | /s/ Dale Dickerson |
| Bruce Vest, M.D. | Dale Dickerson, Ed.D |
| Vest Medical | Chairman, Board of |
| Consultants, Ltd. | Directors Wood River |
| | Township Hospital |

Notwithstanding the use of the phrase

"proposes to lease" in the first sentence of the above document, it is only lease agreement between Wood River Hospital and Computerized X-Ray regarding the Model 9800 Scanner. On July 5, 1983, GE delivered to Wood River Hospital the Model 9800 Scanner that had been purchased by petitioner.

During the latter part of 1983, petitioner upgraded the Model 9800 Scanner, with Wood River Hospital's approval, by adding a supplementary array processor and an additional disc drive (upgrade equipment). Computerized X-Ray purchased this equipment from GE by Installment Contract signed on October 24, 1983. The purchase of this upgrade equipment required Wood River Hospital to increase its monthly lease payments to Computerized X-Ray by $1,970.85 beginning in January, 1984. The board of directors of Wood River Hospital approved the upgrade equipment without written addendum to the Contract for Lease.

Pursuant to the terms of the Contract for Lease, Wood River Hospital paid Computerized X-Ray Services the base monthly rental of $13,634.92, plus the additional $5,000 per month (with the exception of September, 1984, when Wood River Hospital incurred maintenance expenses of $21,533.32), and the upgrade rental of $1,970.85 per month (again with the exception of September 1984). The total monthly lease payment was $20,604.92.

During 1983, petitioner and Mr. Cowsert, president of Wood River Hospital, discussed the availability of the investment credit for the Model 9800 Scanner. In the course of that conversation, Mr. Cowsert provided petitioner with written information, dealing with the so-called noncorporate lessor rules of section 46(e)(3)(B), that suggested that the investment credit was not available to petitioner for Model 9800 Scanner. Petitioner maintained that written information in his tax files.

On their 1993 Federal income tax return, petitioners claimed a regular investment credit in the aggregate amount of $121,000. In computing that credit, petitioners included the cost of the Model 9800 Scanner and the upgrade equipment, array processor, and disc drive, added later. Their return sets forth the following schedule of the property included in computing the tentative regular investment credit for 1983:

| COMPUTERIZED X-RAY SERVICES | COST | | ITC |
|---|---|---|---|
| 3 YR. PROP. | 12,000 | 60% | 720 |
| 5 YR. PROP. | 1,184,402 | 100% | 118,442 (sic) |
| OIL DRILLING PARTERNSHIPS | 11,110 | 100% | 1,111 |
| T.B. & E.P.VEST | | | |
| 3 YR. PROP. | 10,100 | 60% | 600 |

| | | | |
|---|---|---|---|
| 5 YR. PROP. | 2,435 | 100% | 243 |
| TOTAL INVESTMENT CREDIT | | | 121,116 |

Petitioners were not able to utilize the full investment credit of $121,000 claimed for 1983. They carried back $65,800 of the 1983 credit to 1982 and received a refund of 1982 tax in that amount.

In computing the subject tax deficiencies for 1982 and 1983, respondent allowed $20,472 of the regular investment credit claimed by petitioners for 1983 and disallowed the remainder, $100,528. The notice of deficiency describes this adjustment as follows:

> The amount allowed for 1983 is consistent with the determination that the GE 9800 CAT Scanner and the 9800 CT Lin Array were leased during 1983 to Wood River Township Hospital, a tax-exempt entity, for a term no less than 5 years and, therefore, no qualified investment is allowable, although claimed, for those properties for 1983.

Warranty Expense

The model 9800 Scanner was covered by a factory warranty, but the record in this case does not contain the warranty. Normally, the purchase price of a Model 9800 Scanner includes a charge for a 1-year warranty covering the equipment.

Occasionally, GE sells a model 9800 Scanner without a factory warranty, and it reduces the purchase price accordingly.

When a Model 9800 Scanner is purchased from GE pursuant to a monthly installment contract, GE sends monthly invoices to the purchaser. Usually, these invoices do not specify how much of the payment is attributable to the factory warranty. In this case, shortly after purchasing the Model 9800 Scanner, petitioner discussed the cost of the warranty with GE's Sales Manager, Mr. David C. Meek. Mr. Meek sent to petitioner invoices for each of the five installments payable for September 1983 through January 1984. Each of the invoices for $17,819.44 but contained the words "warranty portion of monthly portion is $7,086.66". Petitioner paid those five invoices during 1983.

On the Schedule C for Computerized X-Ray Service, filed with petitioners' 1983 income tax return, petitioners deducted $66,011 for repairs. Of that amount, $35,433 is the aggregate cost of the warranty on the Model 9800 Scanner which petitioner paid during 1983, in accordance with the GE invoices (i.e., $7,086.66 x 5). Respondent disallowed that amount in the notice of deficiency and allowed the remaining $39,357.24 of the deduction claimed. The notice of deficiency explains the reason for the adjustment as follows:

> It has not been substantiated that any more than $39,357.24 is allowable

for 1983.

Examination of Petitioners' 1983 Return

During the latter part of 1985, respondent assigned Revenue Agent Robert Meyer to examine petitioners' 1983 income tax return. Agent Meyer first contacted petitioner by telephone in December 1985. During that telephone conversation, Agent Meyer scheduled an appointment with petitioner for February 18, 1986. When later confirming the appointment, Agent Meyer requested that petitioner bring to the meeting copies of all leases of the Model 9800 Scanner.

On February 18, 1986, Agent Meyer met with petitioner at petitioner's office. Petitioner did not produce all the documents Agent Meyer believed to be necessary for the examination. Therefore, Agent Meyer scheduled another appointment with petitioner for February 20, 1986.

Agent Meyer returned to petitioner's office on February 20, 1986. Again, Agent Meyer concluded that petitioner had not assembled all of the necessary records. Petitioner then left his office and returned with additional documentation. The record does not state how long petitioner was absent.

Upon petitioner's return to his office on February 20, 1986, and in response to inquiry by Agent Meyer, petitioner produced a document, entitled "Operating Agreement", which petitioner

said was the lease of the Model 9800 Scanner to Wood River Hospital. That document states as follows:

OPERATING AGREEMENT

This is an agreement between COMPUTERIZED X-RAY SERVICES ("Owner") and WOOD RIVER TOWNSHIP HOSPITAL ("Hospital").

WITNESSETH:

WHEREAS, Owner is the owner of a General Electric CT 9800 Scanner System, along with various accessories used therewith, including a Diagnostic Console, a Multiformat Camera, a Supplementary Array Processor, an Additional Disc Drive, and 3 film cassettes (all of the foregoing items owned by Owner are hereinafter referred to as the "Scanner");

WHEREAS, Hospital desires to obtain the right to use and operate the Scanner when necessary for diagnosis and treatment of its patients and therefore desires to enter into the Operating Agreement with Owner to set forth the conditions under which it will use and operate the Scanner:

NOW, THEREFORE, Owner and Hospital agree as follows:

1. Hospital's Right to Use. Owner agrees that Hospital shall have the right to use and operate the Scanner whenever necessary for the diagnosis and treatment of its patients, subject, however, to supervision and control of such use by Owner.

2. Consideration. As consideration for the right to use and operate the Scanner, Hospital agrees to pay to Owner the sum of $20,300.00 per month each month during the term of this Agreement. Each such monthly payment shall be due on or before the first day of the month. As further consideration for such right, Hospital agrees that it will pay the cost of all maintenance of the Scanner and for insurance on the Scanner of the types and in the amounts that are satisfactory to Owner.

3. Warranty, Maintenance and Insurance. The Scanner is covered by a warranty issued by the General Electric Company for a period of one (1) year from the date the Scanner is first available for use and Owner agrees to take such action as is within its power to ensure that any claims that might be covered by any warranty on the Scanner are submitted to the General Electric Company.

4. Termination. This Operating Agreement shall terminate two (2) years from August 1, 1983;

provided, however, that either Owner or Hospital may terminate this Operating Agreement at any time, with or without cause, prior to the end of such two-year period by giving 90 days' written notice of intent to terminate to the other party. Until this Operating Agreement is terminated, Hospital agrees to provide, without cost to Owner, space in Hospital's facilities for maintenance and operation of the Scanner.

5. Indemnity. Hospital shall indemnify, defend, and hold harmless Owner against all actions, claims, demands, costs, damages, penalties, or expenses of any kind which may be brought or made against Owner by any person or organization whatsoever as a result of any act or neglect of Hospital in connection with its use and operation of the Scanner, the intent of this paragraph being that Owner shall incur no liability as a result of the Hospital's use and operation of the Scanner.

Executed this 22 day of December, 1983.

COMPUTERIZED X-RAY SERVICES

By /s/ Bruce Vest M.D.

WOOD RIVER TOWNSHIP HOSPITAL

By /s/ George Myers

As shown above, the "Operating Agreement" was purportedly signed on December 22, 1983, by Mr. George Myers, the former chairmen of Wood River Hospital's board on behalf of the hospital. In fact, Mr. Myers had not signed the document, and he had never seen it prior to a meeting with respondent's agents on June 19, 1986.

During petitioner's conference with Agent Meyer on February 20, 1986, petitioners also produced a copy of the following document in which he purportedly proposed to donate the Model 9800 Scanner to Wood River Hospital on December 1, 1990 (the gift letter):

> Wood River Township Hospital
> Edwardsville Road
> Wood River, Illinois 62095
>
> Gentlemen:
>
> I am the owner of the General Electric Model 9800 Scanner System ("Scanner"), presently located at your facilities. I would like to propose to make a gift of the Scanner to the hospital, effective on December 1, 1990. If the proposed donation is acceptable, please acknowledge as indicated below.
>
> Sincerely,
>
> /s/ Bruce Vest
>
> Bruce Vest, M.D.
>
> Accepted:

/s/ George Myers

Title

12/22/83

Date

Like the "Operating Agreement", the gift letter was purportedly signed on December 22, 1983, by Mr. George Myers on behalf of Wood River Hospital. Mr. Myers' signature on the gift letter was not made by Mr. Myers.

After meeting with petitioner on February 20, 1986, Agent Meyer contacted Wood River Hospital to verify the "Operating Agreement" and to determine why the term of the lease was only 2 years. On April 23, 1986, a representative of Wood River Hospital gave Agent Meyer a copy of the Contract for Lease, under which the hospital leased the Model 9800 Scanner for a term of 84 months. Petitioner had never mentioned, or provided Agent Meyer with, a copy of the Contract for Lease.

Following receipt of the Contract for Lease, Agent Meyer and petitioner had a "closing conference" during which Agent Meyer proposed to disallow the investment credit claimed by petitioners with respect to Model 9800 Scanner. At that time, Agent Meyer assumed that both the "Operating Agreement" and the Contract for Lease had been validly executed. Petitioner insisted that only the "Operating Agreement" was valid, that the Contract for Lease was a mere negotiation,

and that he was entitled to investment credit on the scanner.

After the closing conference, Mr. Cowsert, president of Wood River Hospital, contacted Agent Meyer and informed him that the Contract for Lease was the only agreement which Wood River Hospital had entered into concerning the Model 9800 Scanner. Subsequently, on June 19, 1986, Messrs. Cowsert and Myers met with Agent Meyer and his supervisor, Mr. Richard Knowles. At that meeting, Mr. Myers, after having been sworn, and under no pressure from either Agent Meyer or Mr. Knowles, executed an affidavit which states as follows:

> I have reviewed the attached operating agreement signed by Dr. Vest and myself. From my review of this document I can state that it is certainly not my signature and I do not recall seeing this prior to today.

Mr. Knowles signed the affidavit as the person who had placed Mr. Myers under oath, and Mr. Cowsert signed as a witness. Mr. Myers died on October 20, 1988.

During 1983, normal operating procedure at Wood River Hospital required every proposed contract to be reviewed by Mr. Cowsert, as president, before it was presented to the board for approval. Mr. Cowsert had never seen the "Operating Agreement" until the June 19, 1986, meeting with Agent Meyer and Mr. Knowles.

At Wood River Hospital, it was also standard practice to retain copies of all leases. The only lease in the Wood River Hospital files in regard to the Model 9800 Scanner was the Contract for Lease.

Transaction with St. Joseph's Hospital

On December 31, 1977, petitioner, acting on behalf of Computerized X-Ray, entered into a Lease Agreement with St. Joseph's Hospital, Alton, Illinois (St. Joseph's). During 1983, St. Joseph's was operated by the Sisters of St. Francis of the Providence of God, an order of nuns of the Roman Catholic Church. Pursuant to this agreement, Computerized X-Ray leased space from St. Joseph's for the purpose of installing and operating a Model 7800 Scanner System (Model 7800 Scanner) that was owned by Computerized X-Ray. This lease was open-ended and could be terminated by either party by giving 45 days' written notice.

By letter dated April 1, 1983, St. Joseph's notified petitioner of its intent to terminate the Lease Agreement as of May 16, 1983. By letter dated April 19, 1983, St. Joseph's extended the termination date to July 31, 1983. As a result, petitioner had the choice of either removing the Model 7800 Scanner or selling it to St. Joseph's. Petitioner chose not to remove the Model 7800 Scanner and, by agreement dated May 13, 1983, he sold the scanner to St. Joseph's for $495,000, effective July 1983.

Petitioners reported a gain of $314,189 from the sale of the Model 7800 Scanner on Form 4797, Supplemental Schedule of Gains and Losses, attached to their 1983 Federal income tax return. This form is used to report gains and losses from sales or exchanges of assets used in a trade or business and involuntary conversions. According to the Form 4797, the gain was computed by adding the amount realized from the sale, $495,000, to the depreciation allowed or allowable, $562,745, and by subtracting petitioners' cost or other basis, $743,565. In passing, we note that $495,000 plus $562,745, minus $743,565 equals $314,180 or $9 less than the gain reported.

Petitioners also reported a long-term capital gain of $314,189 on Schedule D, Capital Gains and Losses. On that form they offset a portion of the gain with a net long-term capital loss for "partnerships, S corporations, and fiduciaries" in the amount of $183,224 and reported the difference of $130,965 as net long-term capital gain.

In the notice of deficiency, respondent recomputed the gain realized from the sale of the Model 7800 Scanner to St. Joseph's and determined that the amount of gain is $319,144, rather than $314,189. Respondent also treated the gain as ordinary income, rather than as capital gain. Accordingly, respondent determined that none of the gain could be offset by the net long-term loss in the amount of $183,224 nor could it be reduced

by the deduction of capital gains set forth in section 1202(a).

Construction of a Temporary Scanner Building and Doctors Clinic

During 1984, petitioner hired Ralph Korte Construction Co. (Korte Construction) to design and construct a multimillion dollar Doctors Clinic. In October 1984, petitioner purchased a Model 9800 Scanner System (clinic scanner) for use in this clinic. At petitioner's direction, Korte Construction erected a temporary building to house the clinic scanner until the Doctors Clinic was completed. The area of this scanner building was approximately 800 square feet. Petitioner performed his work as a radiologist in the building. The cost of the building was approximately $70,000, of which petitioner paid $52,230 on December 30, 1984 . Petitioner caused the structure to be demolished in 1986.

Petitioners deducted the amount that they paid in 1984 for the temporary building, $52,230, on the Schedule C, Profit or (Loss) From Business or Profession, for Computerized X-Ray that accompanied their 1984 income tax return. Respondent disallowed that deduction in the notice of deficiency for the following reason:

> It has not been substantiated that any amount is allowable for Temporary Building for 1984. The adjustment is represented by a nondeductible capital expenditure for which

depreciation is allowable when the facility is placed into service.

Before Korte Construction began construction of either petitioner's scanner building or his Doctors Clinic, petitioner paid Korte Construction a $10,000 fee. This fee was a "retainer", which secured Korte Construction's initial architectural services for both the scanner building and the Doctors Clinic. The services also included advice about the location of possible construction sites, a price quote, and preparation of schematic drawings.

Petitioners did not explicitly list the $10,000 fee as a deduction on their 1984 Federal income tax return. Nevertheless, they claim that the fee was deducted on the Schedule C filed with their 1984 return for Computerized X-Ray services. The "total deductions" set forth on that schedule is "832,461". However, the individual amounts listed as deductions total $780,621, or $51,840 less. In the notice of deficiency, respondent treated the difference between the total of the deductions listed on the return and the specified total as a "computational error in return" and increased petitioners' income by that amount.

OPINION

1. Admissibility of the Affidavit of Mr. George R. Myers

The first issue is whether the affidavit of Mr. George R. Myers is admissible hearsay under rule 804(b)(5) of the Federal Rules of Evidence, the residual exception to the hearsay rule. Mr. Myers executed the affidavit on June 19, 1986, approximately 28 months before his death on October 20, 1988.

Rule 804(b) sets forth five exceptions to the hearsay rule which apply if the declarant is "unavailable", as defined by rule 804(a). The first four of these exceptions permit the admission of former testimony, statements made under belief of impending death, statements against interest, and statements of personal or family history. rule 804(b)(1), (2), (3), and (4). The fifth exception, rule 804(b)(5), provides an additional, residual exception that is applicable in circumstances that fit none of the other four categories. To qualify for admission under the residual exception, the statement must bear "circumstantial guarantees of trustworthiness" equivalent to those found in the other exceptions. Rule 804(b)(5). In addition, a court must determine that:

> (A) the statement is offered as evidence of a material fact; (B) the statement is more probative on the point for which it is offered than any other evidence which the proponent can procure through reasonable efforts; and (C) the general purposes of these rules and the interests of justice will best be served by admission of the statement

into evidence. * * * [Id.]

A "circumstantial guarantee of trustworthiness" is present when the declarant's statement is made under oath with no pressure brought to bear on the witness to make the statement, and the declarant is "a disinterested witness--a mere bystander, with no axe to grind." United States v. Boulahanis, 677 F.2d 586, 588 (7th Cir. 1982); see also United States v. Hooks, 848 F.2d 785, 797 (7th Cir. 1988). Additionally, a circumstantial guarantee of trustworthiness is present when there exists sufficient corroboration of the statement being offered. United States v. Guinan, 836 F.2d 350, 356 (7th Cir. 1988).

We find the affidavit admissible under rule 804(b)(5). Respondent has shown that the affidavit carries "equivalent circumstantial guarantees of trustworthiness" and that it is sufficiently corroborated by other evidence. It is uncontroverted that Mr. Myers signed the affidavit under oath, as a disinterested witness and that respondent's agents exerted no pressure on him to do so. See United States v. Boulahanis, supra at 588. Petitioners' argument that these factors are vitiated by the fact that respondent's agents were the only witnesses to the affidavit fails to account for the fact that Mr. Cowsert also witnessed the document.

Petitioners' argument that the affidavit is flawed to the point of being

untrustworthy is without merit. Although petitioners never explicitly say so, this argument implies that the affidavit could have been altered by respondent. Petitioners have introduced no evidence to support this veiled speculation. The affidavit was executed on a Treasury Department form, which contained standardized "beginning" and "end" pages. Agent Meyer satisfactorily explained that although the affidavit is two pages in length, he stated on the form that the affidavit was one page in length because the substantive portion of the statement was contained completely on one page. Even though Mr. Myers signed only the final page and not each of the two pages as the preprinted portion of the statement requires, this was a standardized form, and the "fine print" apparently was not followed as carefully as it might have been. Respondent's agents failed to delete the blank spaces in the document. However, the entire affidavit is only two sentences long, and there is nothing to suggest that an unauthorized addition was made to the affidavit. Finally, counterbalancing each of these flaws is the testimony of Agent Meyer and Mr. Cowsert, who identified the affidavit as the one they had witnessed.

Respondent has also presented sufficient evidence to corroborate Mr. Myer's affidavit. See United States v. Guinan, supra at 356. The affidavit states that Mr. Myers did not sign the "Operating Agreement" and, in fact, had never seen it prior to his meeting with respondent's agents. That statement is

corroborated by the testimony of Mr. Eugene Cowsert, who was president of Wood River Hospital on the date of the "Operating Agreement" and who would have reviewed such an agreement. He testified that he had never seen the document prior to the time that Agent Meyer presented it to him for verification. He also testified that he conducted a search of records of Wood River Hospital and found no copy of the "Operating Agreement", despite the hospital's business practice of maintaining copies of all contracts. As further corroboration, respondent notes that the "Operating Agreement" was purportedly signed by Mr. Myers after he had been replaced as chairman, contrary to the hospital's policy that the chairman of the board signed contracts. Moreover, respondent has proven that, contrary to petitioners' assertions, Wood River Hospital did not "unequivocally follow each and every term in the 'Operating Agreement.'" See infra pp. 51-52.

Finally, the affidavit satisfies the other requirements of rule 804(b)(5). The affidavit is obviously material to the issue of the validity of the "Operating Agreement." It is more probative than any other available evidence concerning whether Mr. Myers had signed the "Operating Agreement". Further, we find that the interests of justice will best be served by admission of the affidavit into evidence.

2. Investment Credit on the Model 9800 Scanner Leased to Wood River Hospital

Respondent determined that petitioners are not eligible for the investment credit claimed on their 1983 joint income tax return with respect to their investment in the Model 9800 Scanner leased to Wood River Hospital. In order to fully understand the positions of the parties with respect to this issue, it is necessary to briefly review several aspects of the investment credit as it stood during the years at issue. We note that the credit was repealed in 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L 101-508, sec. 11813(a), 104 Stat. 1388, 1388-536.

During the years in issue, the Internal Revenue Code permitted a credit against a taxpayer's income tax liability based upon the taxpayer's investment in certain depreciable property used in the taxpayer's trade or business. Sec. 38(a). As applicable to this case, the amount of the credit generally was equal to 10 percent of the "qualified investment", subject to a limitation based upon the amount of the taxpayer's tax. Sec. 46(a)(2) and (3). "Qualified investment" for a taxable year was defined to mean a certain percentage of the basis of each new "section 38 property * * * placed in service by the taxpayer during such taxable year." Sec. 46(c). The applicable percentage in the case of recovery property, such as involved in this case, was 100 percent. Sec. 46(c)(7).

In general, the definition of "section 38 property" included tangible

personal property and certain other tangible property of a character subject to the allowance for depreciation. Secs. 48(a)(1), 168(c). However, the definition of "section 38 property" provided a number of limitations and restrictions on the kind of property that qualified. See sec. 48(a). One such limitation declared that property used by a governmental agency or instrumentality could not be treated as section 38 property. Sec. 48(a)(5). That limitation provided as follows:

> Property used by the United States, any State or political subdivision thereof, any international organization, or any agency or instrumentality of any of the foregoing shall not be treated as section 38 property. * * *

The regulations promulgated under that provision, section 1.48-(k), Income Tax Regs., stated as follows:

> The term "property used by the United States, etc." means (1) property owned by any such governmental unit (whether or not leased to another person), and (2) property leased to any such governmental unit Thus, for example, a data processing or copying machine which is leased to any such governmental unit would be considered as property used by such governmental unit. Property leased by another person to any such governmental unit or leased by such governmental unit to another person is not section 38 property to either the lessor or the

> lessee, and in either case the lessor may not elect under S 1.48-4 to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to any such governmental unit. [Emphasis added.]

Therefore, property leased to a government entity or instrumentality could not be treated as section 38 property, unless the lease was "casual" or "short-term". Id.

In addition to the above rules dealing with the definition of section 38 property, individuals were not eligible for the credit on property leased to others unless they met certain other rules applicable to noncorporate lessors, which were set forth in section 46(e)(3). That paragraph provided as follows:

> (3) NONCORPORATE LESSORS.--A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if--
>
> > (A) the property subject to the lease has been manufactured or produced by the lessor, or
> >
> > (B) the term of the lease (taking into account options to renew is less than 50 percent of

> the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.
>
> * * * * * * * * * *
>
> For purposes of subparagraph (B), in the case of any recovery property (within the meaning of section 168), the useful life shall be the present class life for such property (as defined in section 168(g)(2)).

The above-cited Code sections and regulations applied only to leases and not to service contracts. Property provided to governmental entities pursuant to a service contract was considered to be "used" by the service provider, and not by the governmental entity. See Xerox Corp. v. United States, 228 Ct. Cl. 406, 656 F.2d 659, 671-675 (1981) (per curiam); Musco Sports Lighting, Inc. v. Commissioner, T.C. Memo. 1990-331, affd. 943 F.2d 906 (8th Cir. 1991); Smith v. Commissioner, T.C. Memo, 1989-318; Rev. Rul. 68-109, 1968-1 C.B. 10. Thus,

property provided to a governmental entity under a service contract did not lose its section 38 property status through application of section 48(a)(5) and the regulations promulgated thereunder. In addition, because such property was not "leased", it qualified for the investment credit without satisfying the additional noncorporate lessor rules of section 46(e)(3). See Xerox Corp. v. United States, supra at 677-678; Smith v. Commissioner, supra.

In this case, we have found that the Contract for Lease is the operative agreement between petitioner and Wood River Hospital regarding the Model 9800 Scanner. Accordingly, we examine each of petitioners' arguments in light of that agreement.

a. Whether the Contract Is a Service Contract or a Lease

Petitioners assert that the agreement with Wood River Hospital is a service contract, as defined in section 7701(e), rather than a lease, and therefore, the scanner qualifies for investment credit without satisfying either the section 48(a)(5) rules and accompanying regulations regarding property used by governmental units, or the noncorporate lessor rules of section 46(e)(3).

Respondent argues that the scanner does not qualify for investment credit because the Contract for Lease is a lease and not a service contract. Respondent also takes issue with petitioners'

assertion that section 7701(e) applies in determining whether the Contract for Lease is a lease or a service contract. According to respondent, preexisting case law, and not section 7701(e), is controlling. We agree with respondent.

Congress enacted section 7701(e) in the Deficit Reduction Act of 1984 (DEFRA), Pub. L. 98-369, sec. 31(e), 98 Stat. 494, 518-521. However, the following transitional rule, DEFRA sec. 31(g)(4)(a),98 Stat. 522, limits the applicability of section 7701(e):

> (A) IN GENERAL -- The amendments made by this section shall not apply with respect to any property leased to a tax-exempt entity * * * if--
>
> (i) on or before November 1, 1983, there was significant governmental action with respect to the project or its design, and
>
> (ii) the lease to the tax-exempt entity is pursuant to a written binding contract entered into before January 1, 1985, which requires the tax-exempt entity to be the lessee of the property.

The lease in this case meets both of the above requirements. First, Wood River Hospital, a political subdivision community hospital, operated as a government entity, and the Model 9800

Scanner was delivered to Wood River Hospital in July 1983. Thus, there had obviously been significant governmental action taken regarding the lease of the Model 9800 Scanner before November 1, 1983. Second, although the Contract for Lease is undated, the testimony in this case proves it was executed before the January 1, 1985, deadline. Therefore, section 7701(e) is not applicable in determining whether the Contract for Lease is a service contract.

We turn to preexisting case law to determine whether the Contract for Lease is a service contract. Smith v. Commissioner, T.C. Memo. 1989-318, involved high-tech medical equipment, a CAT scanner and a special diagnostic camera, each of which had been either leased or provided to a hospital under a service contract. In that case, the Court outlined the following factors to be considered in distinguishing a lease from a service contract:

> (1) which party has the use and possession or control of the equipment; (2) which party operates the machine; (3) whether the tax-exempt organization pays for the use of the machine for some duration or, instead, pays based upon the number of procedures executed; and (4) whether the equipment is part of a broader, integrated system of equipment and services. [Id.]

See also Musco Sports Lighting, Inc. v. Commissioner, 943 F.2d 906, 908 (8th Cir.

1991), affg. T.C. Memo. 1990-331, where the Court of Appeals for the Eighth Circuit approved this four-factor test as "efficient and effective".

In Xerox Corp. v. United States, 228 Ct. Cl. 406, 656 F.2d 659 (1981), the Court of Claims also addressed this issue. It found that the distinction between a lease and a service contract hinged on an examination of two broad areas: (1) The nature of the possessory interest retained by the taxpayer, and (2) the degree to which property supplied to a customer is a component of an integrated operation in which the taxpayer has other responsibilities. Id. at 674. In examining the nature of the taxpayer's psosessory interest, the court examined four secondary factors: (a) The retention of ownership by the taxpayer, (b) retention of possession and control of the property by the taxpayer, (c) retention of the risk of loss by the taxpayer, and (d) reservation of the right to remove the property and replace it with comparable property. Id.

Under both Smith v. Commissioner, supra, and Xerox Corporation v. United States, supra, the Contract for Lease fails to qualify as a service contract. The Model 9800 Scanner was installed within Wood River Hospital's physical plant, and petitioner released control of the machine to Wood River Hospital. Petitioner did not retain the right to use the Model 9800 Scanner to provide CAT scan services on behalf of any other entity. In addition, the Contract for Lease

provides that the Model 9800 Scanner would become property of Wood River Hospital at the end of the 7-year lease term.

The Model 9800 Scanner was operated by employees of petitioner's businesses, but this service was provided through a separate "Radiology Agreement" which had been executed before the parties reached agreement regarding the Model 9800 Scanner. The Radiology Agreement was of 3 years' duration , but it contained a 90-day cancellation clause. Cancellation of the Radiology Agreement would have no legal effect on the status of the Contract for lease. Thus, Wood River Hospital was free to replace the personnel who operated the Model 9800 Scanner, after giving 90 days' notice.

The hospital paid a flat monthly lease fee for the machine. This fee was supplemented by an additional amount, $5,000, required to be paid for each month in which the hospital performed over 50 scans. As discussed above, the purpose of this contingent amount was to allay the fears of the directors of Wood River Hospital that the machine might not prove profitable. Petitioners introduced no evidence that the Contract for Lease and the Radiology Agreement were interdependent; thus, we find that there was no integrated system of equipment and services.

In light of the above, we find that the Contract for Lease is a lease and not a service contract. As such, it is a lease to a governmental entity, and the

property covered under the lease cannot be treated as "section 38 property" unless the lease qualifies as a "short-term" lease. Sec. 1.48-1(k), Income Tax Regs. Furthermore, the Contract Lease must also meet the requirements of the noncorporate lessor rules set forth in section 46(e)(3).

b. Whether the Contract for Lease Is a "Short-Term" Lease and Is For a Term Which Is Less Than 50 Percent of the Useful Life of the Property

Petitioners argue that even if the Operating Agreement is held to be a lease, rather than a service agreement, they are nevertheless entitled to the investment credit claimed on the Model 9800 scanner. They argue that the Operating Agreement is a "short-term" lease for purposes of section 48(a)(5), and that it satisfies the limits imposed under noncorporate lessor rules regarding the term of the lease. In this connection, they argue that the "term of the Operating Agreement is less than 50 percent of the property's useful life, which is 9 years. I.R.C. 168(i)(2); Rev. Rul. 87-56. I.R.B. 1987-42." (Emphasis added.)

Petitioners's argument fails to deal with the possibility that we would find, as we have, that the operative lease agreement between Wood River Hospital and Computerized X-Ray is the Contract for Lease and not the Operating Agreement. Under the Contract for Lease, the term of the agreement is 84 months, i.e., 7 years. Thus, accepting petitioners' contention

that the useful life of the Model 9800 Scanner is 9 years, it is clear that the Contract for Lease is neither a "short-term" lease for purposes of section 48(a)(5), nor is it a lease the term of which is less than "50 percent of the useful life of the property", as required by section 46(e)(3)(B). Accordingly, we sustain respondent's determination that petitioners are not entitled to the investment credit claimed on their 1983 joint income tax return with respect to the Model 9800 Scanner leased to Wood River Hospital.

3. Deductibility of First Year Warranty Expenses Under Section 162(a)

Respondent determined in the notice of deficiency that petitioners are not entitled to deduct $35,433, labeled "repairs" on their 1983 return, as an ordinary and necessary business expense under section 162(a). Respondent asserts that this expenditure must be capitalized under section 263(a). Petitioners bear the burden of disproving respondent's determination on this issue. Rule 142(a). (Hereinafter all Rule references are to the Tax Court Rules of Practice and Procedure.)

Section 162(a) states, "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". Section 1.162-4, Income Tax Regs., provides:

> The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense * * *

Section 263(a)(1) provides that no deduction shall be allowed for "Any amount paid out for * * * permanent improvements or betterments to increase the value of any property or estate." Section 1.263(a)-1(b), Income Tax Regs., provides that expenditures for which a deduction shall not be allowed include "amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment * * *. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures."

Petitioners' contend that they made five payments of $17,819.44 on the Model 9800 Scanner in 1983 and that each of those payments include $7,086.66 for the monthly cost of a 1-year warranty. Thus, they argue that they paid $35,433 (5 X $7,086.66) of the total 1-year warranty expense in 1983 and that this amount is deductible as "ordinary and necessary" expense under section 162(a).

Petitioners argue that the cost of the warranty is a current expense rather than a capital expenditure. They assert that the warranty covered repairs of the scanner for the 1-year period only, and

that it did not prolong the life or enhance the value of the Model 9800 Scanner within the meaning of section 1.263(a)-1(b), Income Tax Regs. Petitioners also argue that the cost of repairs to the scanner, in the absence of a warranty, would be deductible under section 1.162-4, Income Tax Regs. Thus, they argue the warranty cost for 1983 should be deducted currently under section 162(a).

Respondent contends that petitioners are not entitled to deduct the subject $35,433 in 1983 because they did not pay the warranty expense during the 1983 tax year, but rather, paid it over the entire 7-year financing period of the scanner. In the alternative, respondent argues that even if the warranty expense can be segregated and was paid during 1983, it must be capitalized under section 263(a), rather than deducted. Respondent relies on Spritzer v. Commissioner, T.C. Memo, 1988-347, in which this Court stated: "expenditures such as warranty expenses that prolong the life or enhance the value of existing assets are capital in nature." Respondent asserts that under Spritzer, warranty expenses are capital in nature.

We find that petitioners have failed to meet their burden of proof in this issue. Petitioners did not introduce the warranty agreement into evidence. The record contains only vague testimony from a GE employee regarding the extent of the warranty coverage. Based on the record in this case, we do not know what the warranty covered. Thus, even if we agreed

with petitioners that $35,433 of the payments during 1983 is allocable to the factory warranty on the scanner, we do not know what GE undertook to do for that sum. We infer from petitioners' failure to introduce the warranty into evidence that it would not have been favorable to the petitioners. See Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), affd. 162 F.2d 513 (10th Cir. 1947.) Accordingly, petitioners have failed to prove that the warranty coverage "neither materially [added] to the value of the property nor appreciably [prolonged] its life". Sec. 1.162-4, Income Tax Regs.

Furthermore, petitioners' position that they are entitled to a current deduction in 1983 for a portion of the monthly payments for the Model 9800 Scanner fails to account for the fact that petitioners included the entire cost of the scanner, $1,060,200, in computing the allowance for depreciation claimed on the scanner for 1983, $151,078. That amount was computed as follows:

| | |
|---|---|
| Cost of Scanner | $1,060,200 |
| Less 1/2 investment credit | <53,010> |
| Adjusted basis | 1,007,190 |
| 15 percent of adjusted basis | 151,078 |

Thus, for depreciation purposes, petitioners capitalized the entire cost of the Model 9800 Scanner, including the amount allocable to the warranty. They treated the scanner as "5-year property"

within the meaning of section 168(c)(2)(B), and they reduced their basis in the scanner by 50 percent of the investment credit, as required by section 48(g).

4. Whether Petitioners' Sale of their Model 7800 Scanner Constitutes an Involuntary Conversion

As discussed above, petitioners computed the amount of gain realized from the sale of the model 7800 Scanner to St. Joseph's Hospital to be $314,189, and they reported that amount on Schedule D of their 1983 joint income tax return as long-term capital gain. On Schedule D, petitioners offset the gain of $314,189 with long-term capital losses of $183,224, and they deducted 60 percent of the remainder pursuant to section 1202(a). Thus, they included $52,386 in income as a result of the transaction ($314,189 less $183,224 times 40 percent). Respondent determined that the amount of the gain realized from the sale is $319,144, i.e., $4,955 more than the amount reported by petitioners. Respondent also determined that the gain is an ordinary gain, rather than a capital gain, and is fully includable in income.

Petitioners also argue that the action taken by St. Joseph's Hospital in terminating its lease of the Model 7800 Scanner from Computerized X-Ray amounted to the exercise of the power of requisition or the threat thereof by a quasi-governmental entity. Accordingly, petitioners argue that the gain realized

from such transaction in 1983 qualifies as gain from the involuntary conversion of property used in a trade or business, and should be treated as capital gain pursuant to section 1231. Petitioners conclude their argument with the following:

> Consequently, the disposition of St. Joseph's C.A.T. Scanner should be treated as involuntary conversion under Section 1231, rather than as a Section 1245 gain on the sale of equipment used in a trade or business and subject to ACRS recapture.

In passing, we note that petitioners do not contend that the gain realized from the sale to St. Joseph's should not be recognized pursuant to section 1033. Generally, under that section, if the taxpayer replaces property which was involuntarily converted into money by purchasing other property similar or related in service or use within a 2-year period, then the gain realized from the involuntary conversion is recognized only to the extent that the amount realized exceeds the cost of the replacement property. Sec. 1033(a). We also note that petitioners do not take issue with respondent's determination that the gain realized from the transaction is $319,144, rather than $314,189, the amount reported.

As a general matter, we agree with respondent that the phrase "power of requisition or condemnation or the threat or imminence thereof", as used in section 1231(a), requires a taxpayer to show that the property was taken against the will of

the taxpayer by some public or quasi-public entity exercising the power of eminent domain or threatening to use such power. See Koziara v. Commissioner, 86 T.C. 999, 1006-1007 (1986), affd. 841 F.2d 1126 (6th Cir. 1988); Dorothy C. Thorpe Glass Manufacturing Corp. v. Commissioner, 51 T.C. 300, 305 (1968); see also Dear Publication & Radio, Inc. v. Commissioner, 31 T.C. 1168, 1174 (1959), affd. 274 F.2d 656 (3d Cir. 1960). Respondent may also be correct in arguing that petitioners' proof fails to show that St. Joseph's Hospital is such a public or quasi-public entity and that it exercised the power of eminent domain in this case. However, we see no reason to address that issue. It is clear that the respondent's adjustment must be sustained regardless of whether the sale of the scanner to St. Joseph's constitutes an involuntary conversion within the meaning of section 1231(a).

In the notice of deficiency, respondent determined that the gain realized from petitioner's sale of the scanner to St. Joseph's is ordinary gain, as opposed to capital gain. This determination is based on the fact that the scanner is personal property "which is or has been property of a character subject to the allowance for depreciation" and, thus, qualifies as "section 1245 property" as defined by section 1245(a)(3). Therefore, pursuant to section 1245(a)(1), petitioners must recognize as ordinary income the lesser of the depreciation taken on the property, $562,745, or the gain on its sale, $319,144. In this case, section 1245(a)(1)

requires that the excess of the amount realized from the sale, $495,000, over the adjusted basis of the property, $175,856, or $319,144, "shall be treated as ordinary income".

Petitioners argue that the sale of the scanner qualifies as capital gain because the sale was an involuntary conversion within the meaning of section 1231(a). Implicit in this argument is the proposition that section 1245 does not apply to a "section 1231 gain". Petitioners are in error. It is clear that section 1245 applies to involuntary conversions. Section 1245(a)(1)(B)(i) makes specific reference to "a sale, exchange, or involuntary conversion". Thus, section 1245 applies to the gain realized upon disposition of property in an involuntary conversion, and it requires recapture of depreciation, except to the extent that any gain realized is not recognized in whole or in part under section 1033. See sec. 1245(b)(4). In this case, as mentioned above, petitioners do not content that section 1033 applies. Therefore, section 1245 requires petitioners to treat the gain recognized from the disposition of the Model 7800 Scanner as ordinary gain to the extent of the depreciation taken on the property, even if the disposition qualifies as an involuntary conversion.

5. Deductibility of 1984 Construction Costs and Retainer Fee

In the notice of deficiency, respondent determined that petitioner's

payment of $52,230 for construction of a "temporary structure" to house his Doctors Clinic CAT Scanner and his payment of $10,000 to Korte Construction as a "preliminary design fee" are not currently deductible under section 162(a) as ordinary and necessary business expenses. Sec. 1.263(a)-2(d), Income Tax Regs.

Petitioners contend that the payment of $52,230 to Korte Construction on December 30, 1984, for construction of the "temporary structure" to house his Doctors Clinic Scanner is fully deductible in 1984. They assert that section 263(a)(1) which states that "No deduction shall be allowed for * * * Any amount paid out for new buildings" does not apply because, according to petitioners, the temporary structure was not part of the Doctors Clinic, it had a useful life of less than 1 year, it was never depreciated, and it was necessary to petitioner's profession. Petitioners state that restrictive covenants with the former owner of the land required petitioner to destroy the structure, and that he actually did so in 1986.

Respondent contends that this cost is not deductible in 1984, but must be capitalized as required by section 263(a)(1). Respondent asserts that the "temporary structure" was a building, and thus, under the plain language of section 263(a)(1), the cost of its construction is not deductible as a current expense. Respondent points out that the building cost approximately $70,000 to construct, was 800 square feet in area, housed a

piece of high-tech medical machinery worth over $1 million, and was used by petitioner and his staff to provide radiology services.

We sustain respondent's determination in this point. The temporary structure was a "new building", and the costs incurred in erecting the building fall squarely within the language of section 263(a)(1), which provides that no deduction shall be allowed for any amount paid out for "new buildings". The statute is clear, and it makes no exception for erection of buildings with predetermined, finite lives. Moreover, in this case, the record shows that petitioner paid the amount at issue, $52,230, in December of 1984 and that the building was demolished sometime during 1986. Thus, through this expenditure, petitioner acquired an asset which had a useful life that extended substantially beyond 1984. See INDOPCO, Inc. v. Commissioner, 503 U.S. ____, ____, 112 S. Ct. 1039, 1044-1045 (1992). The recovery of the amounts paid through depreciation or as a lose is a separate question that is not presented here.

Petitioners contend that the $10,000 "preliminary design fee" paid to Korte Construction was currently deductible in 1983. They assert that the fee was unrelated to the architectural fees paid for the Doctors Clinic, which they concede were capital expenditures. Petitioners argue that the fee compensated Korte Construction for locating a suitable site for the Doctors Clinic and generating a "concept drawing" for that structure.

Respondent asserts that under section 263(a)(1) and section 1.263(a)-2(d), Income Tax Regs., this expense is capital in nature. Respondent contends that the fee was actually a retainer which petitioner paid to begin the process of designing and building the Doctors Clinic. Thus, the fee must be capitalized as part of the cost of construction of the Doctors Clinic.

We hold for respondent. Although petitioners claim that this expense is unrelated to the construction of the Doctors Clinic, we find that the site location and early architectural services performed by Korte Construction were inherently related to the construction of the Doctors Clinic. Further, as a representative of Korte Construction testified, this fee was a retainer for its architectural and construction services for the clinic project. The retainer did not solely ensure that Korte Construction would locate a site and produce "concept drawings". Korte Construction would not proceed with any portion of the project until petitioner paid the fee.

6. Whether the Underpayments for 1982 and 1983 are Due to Fraud

Respondent determined that for 1982 and 1983 petitioner T. Bruce Vest is liable for the addition to tax for fraud "under section 6653(b), 6653(b)(1)". Respondent also determined that for 1983 petitioner T. Bruce Vest is liable for the addition to tax for fraud under section 6653(b)(2). Respondent did not

determine in the notice of deficiency that petitioner T. Bruce Vest is liable for the section 6653(b)(2) addition for 1982 but made a claim therefor in respondent's answer. Petitioner Evelyn P. Vest is not liable for any fraud additions because respondent determined that "none of the fraud is due to fraud on part of Evelyn P. Vest".

At the outset, we note that Congress amended section 6653(b) in 1982 to add the interest-addition feature contained in section 6653(b)(2). Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 325(a), 96 Stat. 324, 616. This amendment applies to taxes the last day for payment of which (without regard to any extension) is after the date of enactment of TEFRA, September 3, 1982. TEFRA sec. 325(b), 98 Stat. 616. Therefore, the fraud additions set forth in section 6653(b)(1) and (2) are both applicable to taxes for calendar years 1982 and 1983.

Section 6653(b)(1) provides an addition to tax equal to 50 percent of the entire underpayment for the year if any part of the underpayment is due to fraud. To prevail as to this addition, respondent must prove that some part of the underpayment for each year was due to fraud. Section 6653(b)(2) provides an addition to tax "equal to 50 percent of the interest payable under section 6601 * * * with respect to such portion of the underpayment described in [section 6653(b)(1)] which is attributable to fraud." Accordingly, section 6653(b)(2)

applies only to those portions of the underpayment that were due to fraud.

Respondent determined that the portion of the underpayment for 1983 that is attributable to the investment credit claimed on petitioner's investment in the Model 9800 Scanner leased to Wood River Hospital is due to fraud. Respondent also determined that the underpayment for 1982, which was brought about by the carryback of the 1983 investment credit, is entirely due to fraud. Respondent determined that these underpayments are due to fraud on the part of petitioner T. Bruce Vest.

An underpayment of tax is due to fraud if it results from the taxpayer's specific intent to evade a tax believed to be owing. E.g., Wilson v. Commissioner, 76 T.C. 623, 633 (1981), modified 77 T.C. 324 (1981). Respondent bears the burden of proving fraud by clear and convincing evidence. Sec. 7454(a); rule 142(b).

The existence of fraudulent intent is a factual question to be decided on the basis of an examination of the entire record. Plunkett v. Commissioner, 465 F.2d 299, 303 (7th Cir. 1972), affg. T.C. Memo. 1970-274. Fraud may never be presumed but must be established by affirmative evidence. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Because direct proof of a taxpayer's intent is rarely available, however, fraud may be established by circumstantial evidence, which includes conduct calculated to mislead or conceal. Gajewski v. Commissioner, 67 T.C. 181, 200

(1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978; Beaver v. Commissioner, supra at 92-93. Fraud may also be inferred from a taxpayer's entire course of conduct with respect to the transaction in question . Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); Stephenson v. Commissioner, 79 T.C. 995, 1005-1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984); Stone v. Commissioner, 56 T.C. 213, 223-224 (1971).

A deficiency is due to fraud if it is caused by the carryback or carryover of a fraudulent loss from another year. Arc Electrical Construction Co. v. Commissioner, 923 F.2d 1005, 1010 (2d Cir. 1991), revg. on other grounds T.C. Memo. 1993-30; Toussaint v. Commissioner, 743 F.2d 309, 310-313 (5th Cir. 1984), affg. T.C. Memo. 1984-25; Ghidoni v. Commissioner, T.C. Memo. 1991-284; Hall v. Commissioner, T.C. Memo, 1990-244.

Respondent argues that petitioner fabricated the "Operating Agreement" and attempted to convince respondent's agent of its validity. In addition, respondent contends that petitioner's status as a highly educated medical doctor and businessman, his avocation as an "amateur code reader" with a well-developed knowledge of the tax law, and the forewarning that Mr. Cowsert gave petitioner that the investment credit was not available for the Model 9800 Scanner are probative circumstantial evidence that petitioner had the specific intent of evading payment of tax that he believed that he owed.

Petitioner contends that his behavior in regard to the "Operating Agreement" in no way indicates fraudulent intent. Petitioner asserts that he operated under the honest assumption that the Contract for Lease was a "mere negotiation" and that the "Operating Agreement" was the true contract between the parties. He asserts that he personally showed the "Operating Agreement" to Mr. Myers, who took it from him. According to petitioner, the signed "Operating Agreement" was later returned to him through hospital mail, and he never had any reason to assume that it was not valid. Therefore, petitioner argues, even if the "Operating Agreement" is not valid, his reliance on it was reasonable and does not support respondent's fraud claim.

Petitioner further argues that although he is highly educated and is a student of the Internal Revenue Code, he is no expert in Federal tax law. He also argues, contrary to respondent's characterization of his behavior, that he was fully cooperative with respondent's agent and made no false or misleading statements concerning the subject investment credit.

We agree with respondent that a portion of the 1983 underpayment and all of the 1982 underpayment are due to fraud. Respondent has presented clear and convincing evidence that petitioner fabricated the "Operating Agreement" and falsely presented it to respondent's agent in 1986 in an attempt to substantiate the investment credit claimed in 1983 with

respect to his investment in the Model 9800 Scanner leased to Wood River Hospital. The maximum term of the "Operating Agreement" is "two (2) years from August 1, 1983". On the other hand, the term of the Contract for Lease is "Eighty-four (84) months". That 84-month period exceeds the maximum term permitted under the noncorporate lessor rules of section 46(e)(3)(B). "50 percent of the useful life of the property". Similarly, a term of that length would not be considered a "casual or short-term lease" for purposes of section 48(a)(5).

The testimony of Mr. Cowsert at trial and Mr. Myers' affidavit prove that the only agreement between Wood River Hospital and Computerized X-Ray was the Contract for Lease, and that the responsible officers of the hospital had never seen the "Operating Agreement" until several years after its purported signing, when respondent's agent presented them with a copy of it. In his affidavit, Mr. Myers not only states that the signature affixed to the document is not his, but also that he had never seen the "Operating Agreement" before it was presented to him by Agent Meyer.

Similarly, Mr. Cowsert, the president of Wood River Hospital during the subject period, testified that he had never seen the "Operating Agreement" until Agent Meyer brought it to his attention. A search of the hospital's files produced no record that any such contract ever existed, despite the hospital's practice of keeping copies of all such documents.

Furthermore, the "Operating Agreement" bears the purported signature of Mr. Myers, who was no longer chairman of the board at the time of its purported signing, rather than the signature of Mr. Dickerson, who was the chairman at the time.

We also note that, contrary to petitioner's assertion, the conduct of Wood River Hospital during 1983 conforms to the Contract for Lease and not to the "Operating Agreement". This is shown by the fact that the dollar amount of monthly payments made by Wood River Hospital to petitioner for the Model 9800 Scanner conformed to the Contract for Lease. That document requires a payment of $13,635 per month, plus an additional $5,000 in any month in which monthly billing exceeds $20,000, for a total of $18,635. An unwritten addendum, which covered the cost of the upgrade equipment to the Model 9800 Scanner, added $1,970 per month to Wood River Hospital's cost, and brought the total to $20,605. Wood River Hospital's books reflect that the hospital paid $20,604.92 per month to Computerized X-Ray, except for certain amounts paid for a maintenance contract and for additional maintenance.

On the other hand, the "Operating Agreement" requires Wood River Hospital to pay petitioner a flat fee of $20,300 per month for use of the Model 9800 Scanner and its upgrades. No mention is made in the "Operating Agreement" that any portion of the monthly payment was contingent on the number of procedures billed. Thus,

contrary to petitioner's assertion that the hospital's payments to him adhere to the "Operating Agreement", they actually reflect nearly perfect faithfulness to the terms of the Contract for Lease, as amended to account for the upgrade equipment.

Based upon the above, we find that petitioner falsely presented the "Operating Agreement" to respondent's agent in 1986 because he knew that otherwise the credit claimed on his 1983 return would not be allowed. Thus, we infer that in filing petitioners' 1983 joint income tax return, which claimed investment credit with respect to the Model 9800 Scanner leased to Wood River Hospital, and in carrying back a portion of the credit to 1982, petitioner T. Bruce Vest intended to evade tax which he believed to be due.

Respondent has proven by clear and convincing evidence that petitioner acted with fraudulent intent in regard to the investment tax credit claimed on the Model 9800 Scanner in 1983 and carried back to 1982. Therefore, we find that the addition to tax under 6653(b)(1) applies to the underpayments for 1982 and 1983 . We also find that the addition to tax under section 6653(b)(2) applies to the entire underpayment for 1983 attributable to the fraudulently claimed investment credit. These findings make it unnecessary to consider respondent's alternative position that the addition to tax for negligence under sections 6653(a) applies to 1982 and 1983.

7. Whether the Underpayments for 1981 and 1984 are Due to Negligence

Respondent determined that petitioners are liable for the addition to tax for negligence pursuant to "section 6653(a), (a)(1)" for tax years 1981 and 1984. Respondent determined that the entire underpayment for 1981 and a portion of the underpayment for 1984 are due to negligence.

Respondent also determined that petitioners are liable for the addition to tax for negligence pursuant to section 6653(a)(2) for 1984. In the notice of deficiency, respondent determined that $31,412 of the underpayment for 1984 is subject to the addition of tax under section 6653(a)(2). On brief, respondent asserts that this is the amount of the underpayment attributable to two adjustments totaling $83,138, "income from business" ($81,938) and "excess itemized deductions" ($1,200). Respondent did not determine that petitioners are liable for the addition to tax under section 6653(a)(2) for 1981 but made a claim therefor in respondent's answer. Respondent's answer asserts that the entire deficiency in income tax for 1981 was due to petitioners' negligence or intentional disregard of the rules and regulations and, thus, respondent asserts that section 6653(a)(2) is applicable to the entire underpayment for 1981.

At the outset, we note that Congress amended section 6653(a) in 1981 to add the interest addition contained in section

6653(a)(2). Economic Recovery Tax Act of 1981, Pub. L. 97-34, sec. 722(b), 95 Stat. 172, 342. Congress applied the amendment to taxes the last date for payment of which is after December 31, 1981. Id. Therefore, the negligence additions set forth in section 6653(a)(1) and (2) are both applicable to taxes for calendar years 1981 and 1984.

Section 6653(a)(1) provides an additional to tax equal to 5 percent of the underpayment, if any part of the underpayment for the year is due to negligence or intentional disregard of respondent's rules or regulations. In order to prevail on their contention that the additions under section 6653(a)(1) are not applicable, petitioners must prove that no part of the underpayment for 1981 or 1984 is due to negligence or intentional disregard of respondent's rules or regulations. Rule 142(a).

Section 6653(a)(2) provides an addition to tax equal to 50 percent of the interest payable under section 6601 with respect to any portion of the underpayment which is attributable to negligence or intentional disregard of rules or regulations. In regard to 1984, petitioners bear the burden of proving that respondent erroneously determined the negligence addition under section 6653(a)(2). Rule 142(a). In order to prevail, petitioners must prove that the underpayment attributable to the two adjustments which formed the basis of respondent's determination, the income from business and excess itemized

deductions, were not due to negligence or intentional disregard of rules and regulations.

In regard to 1981, respondent claimed the addition to tax under section 6653(a)(2) in the answer. Thus, respondent bears the burden of proving that the addition to tax under section 6653(a)(2) applies to 1981. Rule 142(a); Hyslep v. Commissioner, T.C. Memo. 1988-289; Welch v. Commissioner, T.C. Memo. 1960-163, revd. on other grounds 297 F.2d 309 (4th Cir. 1961). Accordingly, respondent must prove the specific portion of the underpayment for 1981 that is due to petitioners' negligence or intentional disregard of rules and regulations.

For purpose of section 6653(a)(1) and (2), negligence means "'a lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances.'" Neely v. Commissioner, 85 T.C. 934, 947 (1985) (quoting Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967)). A taxpayer is not negligent if a complex legal issue is involved and his or her position is arguable, Yellencsics v. Commissioner, 74 T.C. 1513, 1533 (1980), or if the dispute presents "substantial issues of law and fact", Scott v. Commissioner, 61 T.C. 654, 663 (1974).

The deficiency for 1984, as determined in the notice of deficiency, is based on upon adjustments that increase petitioners' taxable income by $133,003. Each of those adjustments is set out

below, along with the manner in which it was resolved in these proceedings:

| 1984 Adjustments | Conceded by Petitioners | Conceded by Respondent | Disputed |
|---|---|---|---|
| a. Comp. error | | | |
| $51,840 | -- | 42,956.15 | 8,883.85 |
| c. Sales or exchanges of prop. | | | |
| (9,845) | (9,845.00) | -- | -- |
| d. Income from bus. | | | |
| Depreciation | | | |
| 5,126 | -- | 5,162.00 | -- |
| Int. on indebtedness | | | |
| 12,216 | 2,111.00 | 10,105.00 | -- |
| Temporary building | | | |
| 52,230 | -- | -- | 52,230.00 |
| Maintenance on scanner | | | |
| 9,866 | 3,203.69 | 6,662.31 | -- |
| Depreciation | | | |
| 2,500 | 1,250.00 | 1.250.00 | -- |
| e. Loss from parternship | | | |
| 7,870 | 7,870.00 | -- | -- |
| f. Excess itemized deductions | | | |
| 1,200 | 1,200.00 | -- | -- |
| 133,003 | 5,789.69 | 66,099.46 | 61,113.85 |

| Resolved at Trial | For Respondent | For Petitioner | |
|---|---|---|---|
| a. Computation error | | | |
| -- | 8,883.85 | -- | (8,883.85) |
| d. Inc. from business Temporary Building | | | |
| -- | 52,230.00 | -- | (52,230.00) |
| 133,003 | 66,903.54 | 66,099.46 | -- |
| 100.0000% | 50.3023% | 49.6977% | 0.0000% |

Respondent determined that the five adjustments that comprise item d., income from business, in the aggregate amount of $81,938, and the adjustment listed above as item f., excess itemized deductions, in the amount of $1,200 were due to negligence. Thus, respondent determined that $83,138 of the total adjustment was due to petitioners' negligence. We sustain respondent's determination as to adjustments totaling $50,149.69 (i.e., $66,903.54 less item a., $8,883.85, and item e., $7,870). Thus, in computing the addition to tax under section 6653(a)(1) for 1984, the issue is whether the underpayment attributable to the adjustments totaling $50,149.69 was due to petitioners' negligence or intentional disregard of rules and regulations.

Petitioners assert that they used due care and diligence in filing their returns for 1981 and 1984, based on a good faith interpretation of the tax law and that they are not liable for any of the negligence additions determined by respondent. They claim that their 1981 and 1984 returns involved complex transactions wherein there existed substantial issues of law and fact. However, beyond these bare assertions, petitioners offered no evidence as to their lack of negligence regarding any of the adjustments determined by respondent. Therefore, we find that petitioners have failed to carry their burden of proof. Thus, the section 6653(a)(1) addition applies to the entire underpayment in petitioners' 1984 tax and the section 6653(a)(2) addition applies to the underpayment attributable to $50,149.69 of the total adjustments of $66,903.54 sustained by the Court.

For 1981, the deficiency determined in the notice of deficiency is based primarily on a reduction of the amount of investment credit that petitioners had claimed as a carryback from 1984. Petitioners had claimed investment credits on their 1984 return, in the aggregate amount of $101,103. Of that amount, they used $40,681 to offset 1984 tax, and they carried $60,142 to 1981. The record does not really reveal petitioners' treatment of the remaining $280 (i.e., $101,103, less $40,681 and $60,142).

In the subject notice of deficiency, respondent reduced the amount of credit

carryback to 1981 from $60,142 to $44,762, a reduction of $15,380. This reduction is due to the fact that petitioners' taxable income for 1984 was increased by reason of the adjustments described above. This increased the amount of credit that petitioners were entitled to use in 1984 and decreased the amount available as a carryback. Respondent also increased the minimum tax for which petitioners are liable for 1981 from 422,812 to $25,152, an increase of $2,340. The basis for this increase is not readily evident from the record. The deficiency determined by respondent for 1981, $17,720, is the sum of the reduction in investment credit, $15,380, and the increase of minimum tax, $2,340.

As to the addition of tax under section 6653(a)(1), it is evident that the increase of petitioners' taxable income for 1984 which was brought about by the adjustments described above, some of which were due to petitioners' negligence, also caused a reduction of the investment credit carryback of 1981. Therefore, we find some part of the underpayment for 1981 is due to petitioners' negligence and that the addition to tax under section 6653(a)(1) is applicable to the entire underpayment for 1981.

As to the addition to tax under section 6653(a)(2), respondent has failed to prove that the entire underpayment for 1981 is due to negligence of intentional disregard of rules and regulations. In the case of the underpayment attributable to the increase in the minimum tax,

$2,340, we find that the respondent has failed to prove that it was due to petitioners' negligence. In the case of the underpayment attributable to the decrease in the investment credit carryback from 1984, $15,300, we find it is due to petitioners' negligence in the same proportion as the increase in petitioners' income for 1984 is due to petitioners' negligence (i.e., a fraction of which $50,149.69 is the numerator and $66,903.54 is the denominator).

8. Whether Assessment of Tax Deficiency and Additions to Tax for 1982 Is Barred by the Period of Limitations on Assessment

Section 6501(a) sets forth the general rule that "the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed." Ordinarily, if a notice of deficiency is issued within 3 years after the return is deemed to have been filed, the running of the period of limitations is suspended. Sec. 6503(a)(2). On the other hand, if a notice of deficiency is not issued within that period, then as a general rule the assessment and collection of any tax which may be owing for the year are barred. E.g., Hyde v. Commissioner, 64 T.C. 300, 305 (1975).

The bar of the period of limitations is an affirmative defense. Miami Purchasing Service Corp. v. Commissioner, 76 T.C. 818, 823 (1981). Taxpayers, like petitioners, who take this defense must prove the date on which the return was

filed, and the date on which the period of limitations expired. The Commissioner then has the burden of proving that any extension of the period of limitations is applicable. Id.

Section 6501 permits the number of exceptions to the general period of limitations. One exception, contained in section 6501(c)(1), applies in the case of a false or fraudulent return with the intent to evade tax. The exception permits the Commissioner to assess the tax at any time. Another exception, contained in section 6501(j), authorizes the Commissioner to assess a deficiency arising out of an erroneous credit carryback at any time within the period the Commissioner could assess a deficiency for the year in which the credit arose. See sec. 6501(h); Neri v. Commissioner, 54 T.C. 767, 771 (1970); secs. 301.6501(h)-1, 301.6501(j)-1, Proced. & Admin. Regs.

In this case, petitioners' joint 1981 and 1982 income tax returns were filed more than 3 years before respondent issued the notice of deficiency. However, petitioners concede that the subject notice is timely as to 1981 because the entire deficiency for that year is attributable to the carryback of investment credit from 1984, and the period of limitations for 1984 had not expired at the time respondent issued the notice of deficiency. See sec. 6501(j)(1). As to 1982, petitioners argue that respondent failed to prove that the period of limitations was extended under

any of the exceptions to the limitations period. We disagree.

As discussed above, the entire deficiency for 1982 is attributable to the carryback of the investment credit claimed in 1983 in regard to petitioner's investment in the Model 9800 Scanner leased to Wood River Hospital. In as much as the notice of deficiency was timely in regard to 1983, section 6501 (j) permits assessment of 1982 tax based on the erroneous credit carryback from 1983. We need not consider respondent's position that assessment of the 1982 tax determined in the notice of deficiency is also timely under section 6501(c)(1) because petitioners' 1982 return is a "false or fraudulent return with the intent to evade tax".

9. Additions for Understatement of Income Tax

In the notice of deficiency, respondent determined that there was a substantial understatement of income tax for petitioners' 1982, 1983, and 1984 tax years, within the meaning of section 6661. Petitioners bear the burden of proving that respondent's determination is erroneous. Rule 142(a).

Section 661(a) imposes an addition to tax equal to 25 percent of any underpayment attributable to a substantial understatement of income tax which is assessed after October 21, 1986. Pallottini v. Commissioner, 90 T.C. 498, 503 (1988). In the case of a noncorporate

taxpayer, an understatement of income tax is a "substantial understatement" if it exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. Sec. 6661(b)(1).

In this case, petitioners made no argument of any kind regarding the section 6661 additions determined by respondent. For example, they claimed neither that there is substantial authority for the tax treatment of the items in their returns, nor that they adequately disclosed the relevant facts regarding their treatment of disallowed tax items. See sec. 6661(b)(2)(B). Accordingly, we sustain respondent's determination of the additions to tax under section 6661.

To reflect the foregoing and concessions by the Parties.

Decision will be entered under Rule 155

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

Argued February 23, 1996
June 24, 1996

Before

Hon. Kenneth F. Ripple, Circuit Judge
Hon. Daniel A. Manion, Circuit Judge
Hon. Ilana D. Rovner, Circuit Judge

T. BRUCE VEST
and. E.P. VEST,

Petitioners-
Appellants,

Appeal from an order of the United States Tax Court

No. 95-2797

No. 19071-87

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-
Appellee.

ORDER

The Internal Revenue Service assessed tax deficiencies on Dr. and Mrs. Vest for the tax years 1981-1984. The Vests contested the deficiency by filing a petition before the United States Tax Court. The Vests presented nine separate issues to the Tax Court. Following a

hearing and settlement of various issues, in two very thorough opinions the Tax Court upheld tax deficiencies of over $300,000. The Vests appeal, presenting six oF the nine issues to this court. These issues concern the following facts.

Dr. Vest is a doctor who specializes in radiology. In 1981, while he was the head of the radiology department for Wood River Township Hospital, he proposed that the hospital invest in a General Electric Model 8800 Cat Scanner. Before the hospital purchased the Scanner a new and improved (and more expensive) model came out - the Model 9800 Cat Scanner. The hospital, however, did not want to expend the additional funds necessary to purchase the upgrade. So in 1983, Vest proposed to purchase the Model 9800 Scanner and lease it to Wood River Township Hospital. This proposal Was accepted and Dr. Vest and the Chairman of the Wood River Township Hospital Board of Directors entered into a "Contract for Lease of 9800 GE Cat Scanner." Vest later upgraded the 9800 Scanner by adding a supplementary array processor and an additional disk drive, and the hospital increased its monthly lease payments to cover the upgrades. The Vests claimed an Investment Tax Credit for the Model 9800 Cat Scanner and the upgrade equipment totaling $121,000. They also claimed a deduction for a temporary building Dr. Vest had constructed to store a second Model 9800 Cat Scanner which he had purchased, pending completion of a Doctor's Clinic that Vest planned to open.

The Internal Revenue Service ("IRS") investigated the Vests' tax return and specifically the Investment Tax Credit and the deduction for the temporary building. During the investigation, Robert Meyer, the IRS agent in charge, asked Vest to produce all leases relating to the Model 9800 Scanner. Vest, however, failed to present the IRS with the "Contract for Lease of 9800 GE Cat Scanner." Instead he gave the investigating agent an "Operating Agreement," which provided for a 2-year lease of the 9800 Scanner. The Operating Agreement was purportedly signed by George Myers on behalf of the Wood River Township Hospital. Vest also gave the IRS a "Gift Letter" in which he proposed to give the Scanner to the hospital. The "Gift Letter" was also supposedly signed by Myers.

After further investigation, the IRS learned of the existence of the "Contract for Lease." It also questioned Myers concerning the Operating Agreement. Myers signed an affidavit stating that he had not signed the Operating Agreement and did not remember ever having seen it before. Based on its investigation, the IRS determined that the "Contract for Lease" was the controlling instrument and that pursuant to the terms of that agreement the Vests were not entitled to an Investment Tax Credit for the 9800 Scanner or the upgrade equipment. The IRS also determined that the Vests were not entitled to a deduction for the temporary building, ruling instead that they had to capitalize the expenditure. The IRS then assessed deficiencies for the improper

credit and deduction and a penalty for fraud premised on Vest's failure to present the "Contract for Lease," and his reliance on the forged "Operating Agreement."

The Vests filed suit to contest the IRS Commissioner's determination that they were liable for income tax deficiencies. Following a trial, the Tax Court held that the Commissioner had properly denied the Investment Tax Credit and deduction for the cost of the new building. The Tax Court then directed the parties to submit computations of the appropriate tax based on its underlying resolution of the issues. The parties were unable to agree on the computations, so the Tax Court held a further hearing and issued a supplemental opinion assessing a deficiency totaling more than $300,000. The Vests appeal.

On appeal, the Vests claim that the Tax Court erred when it rejected their Investment Tax Credit for the 9800 Scanner leased to the hospital and their deduction for the cost of the building used to store another 9800 scanner. The Vests also assert that the Tax Court erred when it assessed penalties for the Vests' reporting errors. Additionally, the Vests claim that the Tax Court made evidentiary errors and errors in its factual findings. (1) Because the Tax Court extensively and correctly addressed all of the Vests' contentions in the 65-page original and 19-page supplemental opinion, we affirm on the basis of the reasons set out in those detailed decisions. We add the following

in summary.

The Tax Court concluded that the Vests were not entitled to an Investment Tax Credit on the 9800 Scanner because the "Contract for Lease" stated that the lease term was seven years and the Internal Revenue Code and Treasury Regulations provisions in effect at that time precluded such long-term leases from qualifying for an Investment Tax Credit. Specifically, Treasury Regulation section 1.48-1(k) provided that where property is leased to a governmental entity (which Wood River Township Hospital is) the lease must be "casual or short-term" to qualify for an Investment Tax Credit. The Vests were also precluded from taking the investment Tax Credit based on I.R.C. Section 46(e)(3), which prohibited noncorporate lessors from receiving an investment tax credit if the term of the lease was more than 50 percent of the useful life of the equipment. The Vests admitted that the useful life of the Scanner was 9 years, so the 7-year lease also failed to satisfy this fifty-percent rule.

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(1) In their brief, the Vests also contend that the Tax Court erred because it did not address their claim for depreciation. The Commissioner claims there was good reason - the depreciation issue had been conceded. The Vests did not respond to this point in their reply brief, but because the record contains statements by the parties agreeing on the amount of depreciation, this issue is moot.

The Vests do not dispute that under the terms of the "Contract for Lease" they do not qualify for an Investment Tax Credit. Instead, they argue that the "Contract for Lease" was merely a preliminary negotiation between Dr. Vest and the hospital and that it was the "Operating Agreement" that controlled. Since the "Operating Agreement" provided for a two-year lease, the Vests contended that they are entitled to the Investment Tax Credit. The Tax Court rejected the Vests' position, however, finding that the "Contract for Lease" controlled. In doing so, the Tax Court relied on Myers' affidavit wherein Myers stated that he had not signed the "Operating Agreement" or the "Gift Letter" and that he did not recall ever having seen those documents before. The Vests contend that the Tax Court erred in admitting this evidence and that without this evidence its finding that the "Contract for Lease" governed is unsupported.

We review a court's evidentiary decision for an abuse of discretion. United States v. Mokol, 939 F.2d 43, 438 (7th Cir. 1991). The Tax Court admitted this evidence pursuant to the Federal Rule of Evidence 804(b)(5). Rule 804(b)(5) provides a general exception to the hearsay prohibition, making an out-of-court statement admissible, where a declarant is unavailable because of death:

> A statement not specifically covered by any of the [other] exceptions but having equivalent circumstantial guarantees of trustworthiness, if the

> court determines that (A) the statement is offered as evidence of a material fact; (B) the statement is more probative on the point for which it is offered than any other evidence which the proponent can procure through reasonable efforts; and (C) the general purposes of [the rules of evidence] and the interests of justice will best be served by admission of the statement into evidence.

Fed. R. Civ. Pro. 804(b)(5)

It was not an abuse of discretion for the court to admit Myers' affidavit into evidence. Myers voluntarily made the statements under oath; he was unavailable due to his death; and there was other corroborating evidence. United States v. Snyder, 872 F.2d 1351, 1355-56 (7th Cir. 1989)(setting forth the above factors as relevant in the 804(b)(5) analysis). See also United States v. Kladouris, 964 F.2d 658, 664 (7th Cir. 1992)(district court did not abuse its discretion in admitting pursuant to 804(b)(5) grand jury testimony where declarant was deceased and statement contained necessary guarantees of trustworthiness). The Vests contend that the affidavit should have been excluded because Myers was not an unbiased witness given that Dr. Vest and Wood River Township Hospital were in "fierce competition" with each other. Even if it were reasonable to assume that competitors would have an incentive to perjure themselves in an unrelated legal matter, the Vests admit that Myers' affidavit was

repetitive of other evidence, so even if it were error to admit the affidavit, any error was harmless. This other evidence consisted of testimony by a handwriting expert that the signature on the affidavit was not that of Mr. Myers. Additionally, the president of Wood River Township Hospital testified that he had never seen the Operating Agreement, nor was it in the hospital files, as it would have been had it been executed by the hospital. This evidence was sufficient for us to conclude that the Tax Court did not commit clear error in finding that the Contract for Lease governed the lease of the 9800 Scanner.(2) Estate of Whittel v. C.I.R., 994 F.2d 379, 381 (7th Cir. 1993) ("We owe no special deference to the Tax Court on a legal question, but when we consider the application of the legal principle to the facts we will reject the Tax Court decision only if it is clearly erroneous.").

The Vests also appeal the Tax Court's decision rejecting their claimed deduction of $52,230, which was the cost of the building erected to store a 9800 Scanner. Section 263(a)(1) of the I.R.C. provided in relevant part that "no deduction shall be allowed for ... any amount paid out for new buildings ..." The Vests nonetheless argue that since the building was

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(2) The Vests argue that the "Contract for Lease" was really a service agreement and as such qualified for an Investment Tax Credit. The Tax Court rejected this argument and we agree with that determination.

temporary in nature, they were entitled to deduct it fully in the year of construction. The Vests fail to cite any statutory or case law excepting buildings which are temporary in nature, and we see no reason to depart from the clear import of Chapter 263. Thus, the $52,230 deduction was properly rejected.

Dr. Vest also appeals from the Tax Court's decision affirming the IRS' penalty assessments for fraud. (No penalty for fraud was assessed against Mrs. Vest.) A finding of fraud is a finding of fact reviewed for clear error. Plunket v. C.I.R., 465 F.2d 299, 303 (7th Cir. 1972). Section 6653(b)(1) of the I.R.C. provided for an addition to the tax equal to 50% of the entire underpayment for the year if any part of the underpayment was due to fraud. And Section 6653(b)(2) provides an addition to tax equal to 50% of the interest payable under section 6601 if the underpayment is due to fraud.

The Tax Court did not commit clear error in finding that Dr. Vest claimed a tax credit after having been informed by the hospital that he was not entitled to such a credit. Even more damaging is the fact that Dr. Vest concealed the "Contract for Lease" which clearly prevented him from claiming the Investment Tax Credit and instead produced the "Operating Agreement" and "Gift Letters" which would have allowed the Investment Tax Credits, but which contained false signatures. This was more than ample evidence to support the Tax Court's findings of fraud.

The Tax Court also affirmed the IRS's assessment of penalties for negligence and for substantial understatement of a tax liability. The Commissioner may impose such penalties, and the ones imposed were proper for the same reasons supporting the fraud penalties. The Commissioner may also assess a "substantial understatement penalty" if the amount of tax shown on the return is understated by the greater of ten percent of the proper tax, or $5,000. I.R.C. chapter 6661(b)(1)(A). The Vests do not dispute that the understatement satisfied these requirements. Rather, they claim that the understatement penalty should be reduced because they had substantial authority to support their position. Given the Tax Court's finding of fraud, however, it was not error for the Tax Court to also conclude that the Vests' position was not substantially supported.

The Vests further argue that the Tax Court erred when it refused to consider their request to offset their deficiencies with a net operating carryback. The Tax Court refused to consider this issue because the Vests did not present it until after the court had issued its opinion of deficiency. Under Rule 155(c) all that remained was for the Tax Court to calculate the deficiency should the parties be unable to agree, and:

> Any argument under this rule will be confined strictly to consideration of the correct computation of the deficiency, liability, or overpayment resulting from the findings and

> conclusions made by the Court, and no argument will be heard upon or consideration given to issues or matter disposed of by the Court's findings and conclusions or to any new issues.

Rule 155(c).

Because the Vests did not raise their argument concerning the net operating carryback prior to the Rule 155(c) submission, the Tax Court acted within its discretion in refusing to consider this new issue.(3)

The Tax Court extensively considered and discussed the issues presented by the Vests in not one but two opinions. We agree with the Tax Court's analysis and conclusions therein, and for these reasons and the reasons set forth above, we AFFIRM.

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(3) The Vests also claim that the Tax Court erred in assessing a deficiency for their 1982 tax year, but conceded that this argument is valid only if they succeed in convincing this court that they are entitled to an Investment Tax Credit. They did not, so we need not address this issue.

AMENDMENT V [1791]

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

AMENDMENT VI [1791)

In all criminal prosecutions, the accused shall enjoy the right to a speedy and public trial, by an impartial jury of the State and district wherein the crime shall have been committed, which district shall have been previously ascertained by law, and to be informed of the nature and cause of the accusation; to be confronted with the witnesses against him; to have compulsory process for obtaining witnesses in his favor, and to have the Assistance of Counsel for his defence.

The pertinent part of Supreme Court Rule 804 involved in this Petition reads as follows:

> "Rule 804(b)(5): (b) Hearsay Exceptions. The following are not excluded by the hearsay rule if the declarant is unavailable as a witness:
>
> (5) Other exceptions. A statement not specifically covered by any of the foregoing exceptions but having equivalent circumstantial guarantees of trustworthiness, if the Court determines that (A) the statement is offered as evidence of a material fact; (B) the statement is more probative on the point for which it is offered than any other evidence which the proponent can procure through reasonable efforts; and (C) the general purposes of these rules and the interest of justice will best be served by the admission of the statement into evidence. However, a statement may not be admitted under this exception unless the proponent of it makes known to the adverse party sufficiently in advance of the Trial or hearing to provide the adverse party with the fair opportunity to prepare to meet it, the proponent's intention to offer the statement and the particulars of it, including the name and address of the declarant."

## ARTICLE VIII. OFFENSES AND PENALTIES

### 1558-1. False statements or entries

Any officer, director, employee or agent of any corporate fiduciary who shall willfully and knowingly subscribe to or make, or cause to be made, any false statement or false entry with intent to deceive any person or persons authorized to examine into the affairs of such corporate fiduciary or with intent to deceive the Commissioner or his administrative officers in the performance of their duties under this Act upon conviction thereof shall be guilty of a Class 3 felony.

Added by P.A. 85-858, paragraph 1, eff. Jan. 1, 1988

DISTRICT COUNSEL
Internal Revenue Service

MIDWEST REGION
Room 720
220 W. Washington Street
Springfield, Illinois 62701

CC:SPR-TL
DRReid
(217) 492-4540

AUG 19 1988

Steven H. Akre, Esquire
7911 Forsyth Blvd., Suite 650
St. Louis, Missouri 63105

In re: T. Bruce Vest and E. P. Vest
Docket No. 19071-87

Dear Mr Akre:

The purpose of this letter is to respond to your telephonic request on August 15, 1988, for specific infocmation in this case.

With regard to the Affidavit of George R. Myers, it states in pertinent part as follows: "From my review of this document I can state that it is certainly not my signature and I do not recall seeing this prior to today." Of course, this statement relates to the alleged signature of Mr. Myers on the Operating Agreement at issue in this case. It is our intention to call Mr. Myers as a witness in this case. For your information, I decided, for strategic reasons, to send you the text of Mr. Myers' statement as compared to sending you an actual copy of the Affidavit. Nonetheless, I want to notify you that it is respondent's position that the alleged Operating Agreement was forged and that Mr. Myers did not sign it on behalf of himself or the hospital. I am providing you with this information at this time in hopes of possible settlement of this issue.

Concerning the respondent's adjustment as contained in the statutory notice of deficiency, for the claimed partnership losses due to Graham 1978, Ltd. and Graham 1983, 8 for the taxable years 1983 and 1984, respectively, it is respondent's position that the petitioners' losses are limited to the amounts at risk as provided by I.R.C. § 465. Essentially, in addition to other arguments which the respondent may make with regard to such tax shelter activities, it is our position that the petitioners did not contribute amounts considered at risk as defined by I.R.C. § 465(b) to qualify for the claimed losses. Therefore, the claimed loss for 1983 was reduced to zero and the claimed loss for 1984 was reduced to $8,218.00.

CC:SPR-TL



Of course, to the extent that you can provide us with documentation or other evidence to show that the petitioners were at risk up to the claimed loss amounts, we will revisit this issue. Such documentation should be provided to us as soon as possible for purposes of preparing this case for trial.

It is hoped that the above information, through informal discovery, will assist you in the preparation of this case for trial. In this regard, this office will prepare a draft stipulation of facts and provide it to you in the near future. The exact time table for our preparation of the stipulation of facts is somewhat contingent upon the examination of the documents you submitted to us at our meeting on August 9 1988, and any settlement of some issues based on that documentation.

Finally, for purposes of the possible use of a handwriting expert to confirm or deny the authenticity of the signatures on the alleged Operating Agreement, we request, through informal discovery, that you provide us with approximately 50 examples of the name of "George Myers" signed by Dr. West. This information should be provided to us on or before September 5, 1988. We request this information despite the fact that you advised me in a telephone conversation on August 15, 1988, that it was unlikely that your client would provide us with this information. Nonetheless, I am requesting same.

If you have any questions in these matters, or if we may be of any assistance, please contact me at (217) 492-4540, or at the address listed above.

Very truly yours,

Jeff P. Ehrlich
District Counsel

By: David R. Reid
David R. Reid
Senior Attorney

UNITED STATES TAX COURT

| | | |
|---|---|---|
| T. Bruce Vest and E.P. Vest<br><br>Petitioners,<br><br>vs.<br><br>Commissioner of Internal Revenue,<br><br>Respondent. | ) | Docket No. 19071-87 |

MOTION TO COMPEL DISCOVERY

Come Now Petitioners, T. Bruce and E.P. Vest, pursuant to Rules 71, 72 and 104 of the Tax Court Rules of Practice and Procedure, and move this Court for an order compelling Respondent, Commissioner of Internal Revenue, to answer Petitioners' Interrogatories and respond to Petitioners' Motion to Produce.

1. On July 5, 1988, Petitioners served Respondent with Petitioners' Interrogatories and Motion to Produce, annexed hereto with Proof of Service.

2. Rule 71 provides that a party has forty-five (45) days after service in which to answer or object to interrogatories, and accordingly, Respondents answers, and objections, if any, to Petitioners' Interrogatories were to be served upon Petitioners on August 19, 1988.

3. Rule 72 provides that a party has thirty (30) days after service to respond in writing to document requests, and accordingly, Respondent's response to Petitioners' Motion to Produce was to be served upon Petitioners on August 4, 1988.

4. This Court has not granted Respondent any additional time in which to answer or object to the interrogatories or respond to the documents request.

5. On August 9, 1988, the parties commenced informal discovery, and as a result of such meeting on or about August 22, 1988, Respondent orally informed the undersigned that based on Petitioners' documentation, Respondent will concede ten (10) or eleven (11) of fifteen (15) issues framed by Respondent for trial (and indicated he will confirm the waiver of these issues in writing as soon as possible).

6. More than forty-five (45) days have elapsed and Respondent has neither filed answers or responses, nor objected to either the interrogatories or document request.

7. This case has been set for October 11, 1988, and discovery was to be completed forty-five (45) days prior to said date, which would be August 27, 1988.

8. The information requested pursuant to Rules 71 and 72 is essential to pretrial settlement of the remaining issues and to Petitioners' preparation of their case; and further, if the remaining issues cannot be settled, Petitioners will be irreparably harmed and trial preparation impaired if Respondent does not answer Petitioners' Interrogatories and respond to Petitioners' Motion to Produce.

WHEREFORE, Petitioners pray this Court enter an order

compelling Respondent to answer all interrogatories and produce all requested documents within ten days of the date of the Court Order, or, in the alternative, sanctions, including (1) an order refusing to allow Respondent to support or oppose and introducing into evidence matters relating to Paragraphs 5 (6) and 5 (8) of Petitioners' Petition or (2) an order striking said Paragraphs or staying further proceedings until compliance with discovery, and such other orders in regard to Respondent's failure to answer and produce as are just.

Dated September 6, 1988

T. Bruce Vest and E.P. Vest

By: _____

Steven H. Akre
Tax Court bar code #AS0028
7911 Forsyth Blvd.
Suite 650
St. Louis, Missouri 63105
(314)-727-2573

Certificate of Service

This is to certify that a copy of the foregoing Motion to compel Discovery, was served upon David R. Reid and Jeff P. Ehrlich, District Counsel, Internal Revenue Service, Federal Building, 320 W. Washington Street, Springfield, Illinois 62708 by enclosing same in an envelope, certified mail, return receipt requested, with postage fully prepaid, and by depositing said envelope in a U.S. Post Office mail box in Clayton, Missouri on the _____ day of _____, 1988.

_____

Steven H. Akre
7911 Forsyth Blvd.
Suite 650
St. Louis, Missouri 63105
(314)-727-2573

WOOD RIVER TOWNSHIP HOSPITAL
BOARD OF DIRECTORS

MEETING OF
MARCH 27, 1985

The regular monthly meeting of the Board of Directors of Wood River Township Hospital was called to order by Dr. Dickerson, Chairman, at 7:30 p.m., in the Manley Auditorium.

Directors Present: Dr. Dickerson, Mr. Myers, Ms. Calvin, Mr. Pulaski, and Mr. Brueggemann.

Also Present: Mr. Cowsert, President; Mr. Fleetwood, Senior Vice President; Ms. McCune, Vice President of Nursing; Mr. McGinnis, Vice President of Finance; Dr. Asebey, Chief of Staff; and Ms. Bellm, Secretary.

A motion was made by Mr. Myers, seconded by Ms. Calvin, to approve the minutes of the regular meeting of February 27 and the special meeting of March 18, 1985. Motion carried.

OLD BUSINESS

A motion was made by Mr. Myers, seconded by Mr. Brueggemann, to approve the figures submitted by S. M. Wilson, Wegman Electric, and Kane Mechanical to remodel the fourth floor to an Acute Care Rehab Unit at a maximum cost of $120,350.00. Dr. Dickerson called for a vote: Mr. Myers - aye; Ms. Calvin - aye; Mr. Pulaski - aye; Mr. Brueggemann - aye; and Dr. Dickerson - aye. Motion carried.

A motion was made by Ms. Calvin, seconded by Mr. Pulaski, to accept the Rehab Care Corp. contract as amended (Page 4, Rehab Care will furnish $60,000 as grant to Hospital for renovation of acute rehab area.). Dr. Dickerson called for a vote: Mr. Myers - aye; Ms. Calvin - aye; Mr. Pulaski - aye; Mr. Brueggemann - aye; and Dr. Dickerson - aye. Motion carried.

A motion was made by Mr. Myers, seconded by Ms. Calvin, to enter into Executive Session at 8:05 p.m. to discuss contract negotiations. Dr. Dickerson called for a vote: Mr. Myers - aye; Ms. Calvin - aye; Mr. Pulaski - aye; Mr. Brueggemann - aye; and Dr. Dickerson - aye. Motion carried.

A motion was made by Ms. Calvin, seconded by Mr. Myers, to go back into regular session at 10:20 p.m. Dr. Dickerson called for a vote: Mr. Myers - aye; Ms. Calvin - aye; Mr. Pulaski - aye; Mr. Brueggemann - aye; and Dr. Dickerson - aye. Motion carried.

Mr. Brueggemann made a motion, seconded by Mr. Myers, that in view of the fact the Board is reviewing all physician contracts, due notice be given Dr. Vest that the Board intends to renegotiate radiology contracts and at this time initiates a 90-day notice for termination of his contracts. Motion carried.

Honor, under Rule 1003 a duplicate is admissible to the same extent as an original unless (1) a genuine question is raised as to the authenticity of the original --

THE COURT: Well, he's raised a question.

MR. BITNER: That's my point, Your Honor, I believe through the witness I can -- the witness says, I should say can testify that this is a copy of the affidavit that they saw executed.

Your Honor, I have just been informed that we, in fact, have the original of the document here in the courtroom today.

THE COURT: Well, that solves the problem. Why don't you show it to Mr. Akre.

MR. BITNER: Very good.

(Pause.)

MR. AKRE: Your Honor, I'm still going to object to this. It once again has the statement that it consists of one page, each of which he has signed. There's no signature on the first page. According to 804, it's not written. It's a typed affidavit. There is a question whether the declarant had a motive to lie. There's a question to the trustworthiness of the statements, whether they correlate to the whole case, whether he was pressured into signing this affidavit.

MR. BITNER: Your Honor, I think to engage in idle

speculation on that point is better left for the examination of witnesses.

MR. AKRE: Was he represented by counsel?

THE COURT: Well, you can address the Court with questions like that.

MR. AKRE: And there's a final test under the York case, Your Honor, -age. And there's a question as to whether age played a factor in the trustworthiness of this affidavit.

THE COURT: Age of the document or age of the witness?

MR. AKRE: Age of the declarant. The witness.

THE COURT: Are you saying that a writing under 804 means handwriting?

MR. AKRE: Well, it's a technical interpretation, Your Honor.

THE COURT: I'm just asking what you meant.

MR. AKRE: Yes.

THE COURT: All right.

MR. AKRE: I think the rule is not to be used as a catch-all.

THE COURT: All right. I'll listen to the witnesses when we get to there. Any other --

MR. BITNER: Yes, just to clear up the record also, Your Honor, the Respondent had reserved an objection

didn't you?

A I don't recall one way or the other.

MR. BITNER: May I approach, Your Honor?

THE COURT: Yes.

BY MR. BITNER:

Q Dr. Vest, directing your attention to me, we'll get to the exhibits. Let the record reflect I've placed Exhibits 10J, 11K and L on the witness stand.

A Yes.

Q Dr. Vest, directing your attention to Exhibit 11K, the operating agreement. At your second meeting with the revenue agent, you provided him with that agreement, did you not?

A As far as I know, all the documents were there at that time.

Q Let's just zero in on 11K, if you would, the operating agreement. Did you have a chance to look at that, Doctor?

A I see what you have here, yes.

Q And you're familiar with that document?

A Yes, I am.

Q And you gave it to the revenue agent, didn't you?

A Yes.

Q And you told him that that was a genuine lease with Wood River Township Hospital, didn't you?

A This was the operating agreement for the use of the CAT scanner.

Q That's correct. I'm sorry -- I didn't get your answer.

A It is the operating agreement.

Q But that's not my question, Doctor. My question is you told the agent that that was a genuine lease with Wood River Township Hospital, didn't you?

A Yes. . Yes.

Q Now, you didn't give him a copy of what's in front of you as Exhibit 10J, did you?

A Oh, yes. They were all together.

Q You gave him a copy of that?

A Sure. Sure. That was a part of the records. All my records.

Q Now, Dr. Vest, turning to Exhibit 11K, which is the operating agreement, that's got a two-year term in it, does it not?

A Yes.

Q Now, you told the revenue agent that at the time that was executed, you had no firm intent to renew. Is that correct?

A It was up to the hospital to renew the contract.

Q But maybe it was negotiable. To renew.

A They had the right to renew it.

MR. BITNER: Your Honor, I would request that Mr. Akre not shake his head yes or no when I am asking my questions.

THE WITNESS: Of course they had a right to renew it.

THE COURT: All right.

BY MR. BITNER:

Q Dr. Vest, directing your attention to the operating agreement, where was that signed?

A Pardon?

Q Where physically was that signed? In what location?

A I gave this document to Mr. Meyers as I did the original document, 10J, and I got a copy back signed.

Q No, no. Let's take this one step at a time. Where were you physically located when the operating agreement was signed?

A Okay. Where was I physically located?

Q Yes.

A I don't know where I was when it was signed.

Q When you signed it, where were you?

A I signed it and gived it to him.

Q Where were you when you signed it?

A In the CAT scan room at Wood River Hospital.

Q Okay. Was it already signed by George Meyers?

A No, I give it to him.
Q Did you see George Meyers sign it?
A No.
Q Where is the original of that document, Doctor?
A He's got it. The hospital's got it, I guess.
Q Who made the copies of that document?
A I don't know who made it. I give him the original, I got a copy back, similar I did to what I did to the other contract.
Q So you had an unsigned -- who prepared that document?
A I did.
Q You prepared that document. Okay. Dr. Vest, directing your attention to Exhibit L, that's a letter by you to Wood River Township Hospital. Are you familiar with that document?
A Yes. Yes, I am.
Q Where were you physically located when that was signed?
A I was physically located when that was signed at my home when I typed it up.
Q Okay. That's your home in Alton, is that correct?
A Yes.
Q Did you see George Meyers sign that document?
A No.

A I called back and spoke with Mike McGeiness and he had confirmed again that there had only been one agreement ever and we discussed that and I believe he said that Mr. Eugene Cowsert --

MR. AKRE: Objection, Your Honor. Hearsay.

MR. BITNER: I'll withdraw the question, Your Honor.

THE COURT: All right.

BY MR. BITNER:

Q After you had that conversation with Mike McGeiness, I believe you testified, what did you do next?

A I believe nothing that day. The next day, Mr. Eugene Cowsert called me, on the 18th of June, 1986. He confirmed again what Mr. McGeiness had said and he was adamant that there had only been one agreement ever between the parties.

Q After that, did you discuss the matter with your group manager?

A Yes, I did.

Q Could you tell the judge for the sake of the record what your group manager is? Who is your group manager?

A My group manager is my supervisor.

Q In 1983, who was that individual?

A Richard Knowles.

Q Revenue Agent Meyers, in your capacity as a revenue agent, are you authorized to give oaths?

A Yes, I am.

Q Is your group manager?

A Yes, he is.

Q Did you and your group manager ever meet with Mr. Eugene Cowsert?

A Yes, we did.

Q Was anybody else present at that meeting?

A Yes.

Q Do you know when that was?

A Yes, that was June 19, 1986.

Q Revenue Agent Meyer, you have in front of you what's been marked as Exhibit AM. Are you familiar with that document?

A Yes, I am.

Q And that's been stipulated, with objections, as an affidavit of George Meyers. Did you see Mr. Meyers sign that document?

A Yes, I did.

Q Did you see your group manager sign that?

A Yes, I did.

Q Did you see Eugene Cowsert sign that?

A Yes, I did.

Q Did Mr. Meyers read that document before he signed

it?

A Yes.

Q Have you reviewed the original of that document in the courtroom today, Mr. Meyer?

A Yes, I have.

Q Is that document that you have in your hand a true and correct copy of the original?

A Yes, it is.

Q Revenue Agent Meyer, was Mr. Meyers put under oath prior to the time he signed that document?

A Yes, he was.

Q Were any threats made to Mr. Meyers to sign that document?

A No, there was not.

Q Did he sign it as near as you can tell of his own volition?

A Definitely. Yes.

MR. BITNER: I have nothing further at this time, Your Honor. I will, if I may, Your Honor, retrieve my exhibits prior to cross.

THE COURT: All right.

CROSS EXAMINATION

BY MR. AKRE:

Q Mr. Meyer, can you explain to me why on Exhibit AM the affidavit it's stated that there's one page being signed

A Sixteen and a half years.

Q When did you retire?

A July 1989.

Q Directing your attention to 1983, Mr. Cowsert, could you explain to the judge how when Wood River wanted to purchase something by way of a contract or lease something, how did that take place?

A The board would have to approve the lease or purchase of any item $5000 or more. If we were going to be lease-purchasing it, then the accountant or the finance officer would do the computation from the cost, how much interest and so on, and then final approval was done by the board of directors.

Q Who would sign those? Let's say a lease for more than $5000 -- who would sign those?

A Normally signed by the chairman of the board.

Q Did you have any authority to sign those also, Mr. Cowsert?

A No, I did not.

Q Now, directing your attention to 1983, who was the chairman of the board of Wood River Township during 1983?

A Until the May meeting, which would have been the fourth Wednesday of May 1983, Mr. George Meyers was. At the annual meeting, the fourth Wednesday of May, Dr. Dale Dickerson was elected chairman of the board.

MR. BITNER: May I approach, Your Honor?

THE COURT: Yes.

BY MR. BITNER:

Q Mr. Cowsert, I've handed you what has been admitted into evidence as Exhibit 10J. Are you familiar with that document?

A Yes, I am.

Q And I've also handed you what's been admitted into evidence as Exhibit 24Y. Could you take a minute to look at that please? Referring yourself back to Exhibit 10J, that's signed by Dr. Dickerson, is that correct?

A Yes, it is.

Q Now, was the authorization for his signing that based on the minutes of June 22, 1983, set forth in Exhibit 24Y?

A Yes, it was.

Q Mr. Cowsert, if you would set those aside for just a minute, let's again stay in 1983. Do you recall during 1983 Wood River Township's efforts to get a GE 8800 CAT scanner?

A Yes, I do.

Q Could you tell the judge a little bit about that, please?

A Well, it was in 1982 that we decided to go to get a CAT scanner and I believe it was in October of 1982 that

Q Mr. Cowsert, I'm handing you what's been marked for identification as Exhibit AM. Are you familiar with that document?

A Yes, I am.

Q Were you present when George Meyers signed that document, sir?

A Yes, I was.

Q In your mind, were there any threats made by agents of the Internal Revenue Service to Mr. Meyers to sign that document?

A No.

Q Prior to his execution of that document, was Mr. Meyers sworn in by the revenue agent?

A Yes, he was.

MR. BITNER: Your Honor, at this time, the Respondent offers Exhibit AM into evidence.

MR. AKRE: Petitioners object to the introduction of Exhibit AM into evidence on the basis of the technical imperfections of it, the statements made by George Meyers don't indicate -- we don't have an opportunity to cross examine, obviously. And going back to Rule 804, the admission of this should be used sparingly. This is a critical issue in Petitioners' case. The assertion made here is very bold and Petitioners do not have the opportunity to "test" the assertion as being made by Mr.

George Meyers.

MR. BITNER: Frankly, Your Honor, I believe 804(b)(5) is designed for this specific situation -- that being that Mr. Meyers is dead. He is not available. That's the unavailable exception of 804(b) in general. There's no right to cross examine. We agree the rule should be used sparingly, but quite frankly, I think it boils down to Petitioners' objection is this hurts our case. I don't think that's a valid objection.

I, Your Honor, think we've also proven, based on two of the three individuals other than Mr. Meyers who were present at the time executed the affidavit -- if Mr. Akre wants to produce a witness who was there to show that he was in fact threatened, perhaps the Court should wait to rule until that point in time. I don't think he's going to be able to do that.

MR. AKRE: Your Honor, there are other factors other than being threatened. There's the question of trustworthiness, whether Mr. Meyers had a motive to sign this or not, whether he was represented by counsel, whether there are any defects in the affidavit, whether he was under oath, and also it has not been addressed the age of this individual.

Petitioners' understanding at this time, Mr. Meyers was an older person, that he had experienced heart

trouble, that there were occasions when he was forgetful.

MR. BITNER: I'm going to object to that, Your Honor. There is (a) nothing in the record to prove those facts and (b) I have not been informed that there will be anything offered into the record to prove those facts. The fact that Mr. Meyers died --

THE COURT: I'll tell you -- I'm inclined to take it, but I'm not going to -- you both have cited cases that I haven't read, and I haven't -- it seems to me the document is trustworthy, he was under oath; two people that saw the document executed testified, and there are a lot of earmarks of credibility. There are a total of four people who have in effect -- well, three. Mr. Knowles' signature is here and the other one is -- I guess that's your signature.

THE WITNESS: Yes, sir.

THE COURT: Mr. Cowsert has signed it. He's here today testifying. It has a lot of earmarks of credibility. I mean, if you all want to brief it, I'll read the cases. I haven't read them now. It's obviously an important issue. I could agree with this -- well --

MR. BITNER: Your Honor, we'll be more than happy to address it in a brief.

THE COURT: I am inclined to take it.

MR. AKRE: Petitioners would brief it.

THE COURT: You want to brief it? All right.

Q Are there other hospitals of similar size in close proximity?

A Yes, there are.

Q Is there somewhat of a competition among hospitals these days for patients?

A Sure.

Q For skilled physicians to be on staff?

A Sure.

Q For technological equipment to be on the advanced cutting edge, if you will?

A Sure.

Q So there was some competition among hospitals in your area for all of these three factors, is that correct?

A Not as much in 1983 as last year, but there has always been.

Q Was the hospital, Wood River Township Hospital, a political subdivision?

A Yes, it is.

Q And that's organized under Illinois State law? Is that correct?

A Yes.

THE COURT: What was the question?

MR. AKRE: Was Wood River Township Hospital a political subdivision.

THE COURT: Is the hospital a political

subdivision?

MR. AKRE: Yes, Your Honor.

THE COURT: All right.

BY MR. AKRE:

Q And your answer was?

A Yes.

Q Consequently, you had to have open meetings, is that correct? All your board meetings?

A That's correct.

Q You stated earlier the board authorized payments for matters in excess of $500, is that correct?

A Five thousand dollars.

Q Excuse me -- $5000. I'm sorry. When the 9800 CAT scan was upgraded and the additional equipment added pursuant to the contract for the supplemental array and the second disk, was there a contract for that additional amount?

A No, there was not.

Q So the hospital was paying an additional $1970 a month without an additional contract?

A That's right.

Q That's in excess of $5000, isn't it?

A If you total it. But not on a monthly basis.

Q When you total it, isn't it in excess of $5000?

A It would be. Sure.

Q Did you authorize those payments?

A No. The board did.

Q The board authorized the additional payments?

A Yes.

Q When the revenue agent requested certain documents from Wood River Township Hospital, they received copies of board minutes. Is that correct?

A Some board minutes, yes.

Q Board minutes relating to this transaction. Is that correct?

A To the purchase or the lease of the CAT scan. Yes.

MR. AKRE: May I approach the witness, Your Honor?

THE COURT: Yes.

THE COURT: Thank you.

BY MR. AKRE:

Q Mr. Cowsert, I'm handing you Exhibits 20U, 21V, 24Y. These are photocopies of board minutes of the Wood River Township Hospital for the period in question. Can you identify in those board minutes where the approval is for the additional expenditure of $1970 on a monthly basis?

A It is not in these minutes. In fact, that was never even an issue or even raised until in a phone conversation at the time they were there. That issue was not even brought up. The upgrade was not even discussed.

Q Weren't these documents requested of you relating to that?

A At that time, they were not. Not the upgrade. Just the purchase of the CAT scan.

Q So you're saying there may be some minutes somewhere.

A I'm sure there are minutes somewhere on the upgrade.

Q THE COURT: Your Honor, we had requested copies of all those minutes. This is all we have. There was nothing ever provided with any board minutes authorizing this expenditure.

MR. BITNER: That's because I don't have anything, Your Honor.

THE COURT: I think Mr. Akre is just making a record.

BY MR. AKRE:

Q Mr. Cowsert, after the new equipment, the 9800 as well as the additional equipment, was acquired, were payments made by Wood River Township Hospital pursuant to this new increased amount including the $1970?

A Yes, they were.

Q And that included the cost of all of the equipment, is that correct? For the 9800.

A Yes. The original lease agreement plus the

Q-1 and Q-1A in your report. Do you recall that conclusion?

A Yes.

Q Could you tell the Court why you reached that conclusion? Or why you were unable to reach a conclusion?

A That particular document, Your Honor, I would like to point out that Q-1 and Q-1A they were photocopies of each other, but the photocopy process and the condition of that particular photocopy was so poor that it precluded me from formulating an opinion.

Q So in your report, you're unable to express an opinion as to whether Petitioner T. Bruce Vest signed that document as George Meyers?

A That's correct.

MR. AKRE: I object, Your Honor. There's never been any allegation that Dr. Vest did sign this document.

MR. BITNER: I believe he states in his report that he cannot reach that conclusion. That's just the point I'm bringing out.

BY MR. BITNER:

Q Now, Mr. Mongelluzzo, also in your report you state that you were provided with known samples of Petitioner T. Bruce Vest's own signature.

A That's correct.

Q Why were these known samples not sufficient for you to reach a conclusion as to whether Petitioner T. Bruce

A Excuse me, Your Honor. I stand corrected. In Q-2 --

Q It says, "based on the visible portions". My question was are there obviously then portions that are not present, is that correct?

A Only one.

Q After you received the copy, you did request additional copies of all the documents, didn't you? Or better quality?

A I asked if there were better photocopies, particularly of Q-1.

Q Due to the poor quality of all of the documents in question.

A That's correct. I believe I asked for the originals if they were available.

Q You indicate that you -- on Q-2 again, the gift letter -- that apparently George Meyers did not sign that. Does your opinion preclude that George Meyers could have signed it?

A I could find absolutely no evidence that Mr. Meyers could have done this.

Q Well, then speculate. Is it possible that George Meyers, in writing a different way, could have signed it?

A No. No.

Q Do you have any idea who signed it?

A I have no idea.

Q Did anyone assist you in preparing this report?

A No, sir.

Q Then can you tell me whose notations are the initials MLI in this report? Do you know anybody with the initials MLI?

A I don't know what you're referring to.

Q Okay. On it looks like page M-17, it is a copy of -- why don't I just show it to you, if I may.

MR. AKRE: May I approach the witness?

THE COURT: Yes.

BY MR. AKRE:

Q You were the examiner, correct?

A Yes.

Q Can you tell me what that additional language says?

A "Examiner should -- this would be Q-2 -- MLI". Her name is Maggie Ivery --

MR. BITNER: Actually, Your Honor, let the record reflect that the copy of the document which Mr. Akre provided to the witness is not the copy which we put into the record as Exhibit AO.

THE WITNESS: I can, Your Honor, explain why that's there.

THE COURT: Wait. We're talking about the

Q Did Computerized X-Ray Services also find or contract with a radiology group?

A Yes.

Q And that was part of what?

A That my radiology group.

Q Did the payments you received from Wood River Township Hospital comport with what your understanding of the agreement you had with the hospital were?

A Yes, the initial introductory proposal included a payment of $18,634, I believe. The first payment was $13,684 or thereabouts, although we did more than $20,000 the first month, they have never paid that $5000 yet. Maybe they think their next month they're not going to make that.

Anyway, in order to account for the $165,000 additional payments for the linear array and computer, we supplied Mr. Meyers with a contract for an additional $1970 a month, which would bring up the total to $20,300 or something of that nature.

Q That's what you received every month.

A That's what we received, and of course that's the way the contract operated. It operated under the $18,634 from August 1 through December 31. Of course, with the linear array in the second contract, that made it a total of $20,300 or $20,400 or something of that nature, and they've operated according to that from day one.

Q So it's financed through bonds that are offered by it?

A Oh, sure. They had the standard practice in non-profit hospitals is to use tax-free bonds.

Q Is that equipment still operating today?

A It's operating today as well as it did the day I put it in.

Q And when you were forced as you say to sell it, it was converted without your desire, is.that correct?

A I'm sorry?

MR. AKRE: I'll withdraw the question.

THE WITNESS: I'm sorry. I didn't hear it.

BY MR. AKRE:

Q My question was, you didn't want to sell it.

A No.

Q After you had negotiations with Wood River Township Hospital about building this joint venture and you decided to start your clinic, Vest Medical Clinic, in Alton at the Alton Square adjacent to the May Store, did you order any GE equipment?

A Yes.

Q And again, was this the type of equipment you use in the practice of radiology?

A Yes.

Q Was there a jump in the shipping of it versus